TAX-EXEMPT AND TAXABLE GOVERNMENTAL BONDS

HEARING

BEFORE THE

SUBCOMMITTEE ON SELECT REVENUE MEASURES

OF THE

COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES

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TAX–EXEMPT AND TAXABLE GOVERNMENTAL BONDS

THURSDAY, MAY 21, 2009

U.S. HOUSE OF REPRESENTATIVES,
COMMITTEE ON WAYS AND MEANS,
SUBCOMMITTEE ON SELECT REVENUE MEASURES,
Washington, DC.

The Subcommittee met, pursuant to notice, at 10:07 a.m., in Room 1100, Longworth House Office Building, Hon. Richard E. Neal (Chairman of the Subcommittee), presiding.

[The advisory announcing the hearing follows:]

ADVISORY

FROM THE COMMITTEE ON WAYS AND MEANS

SUBCOMMITTEE ON SELECT REVENUE MEASURES

FOR IMMEDIATE RELEASE CONTACT: (202) 225–5522
May 14, 2009

Congressman Neal Announces a Hearing on Tax-Exempt and Taxable Governmental Bonds

House Ways and Means Select Revenue Measures Subcommittee Chairman Richard E. Neal (D–MA) announced today that the Subcommittee on Select Revenue Measures will hold a hearing on issues involving tax-exempt and taxable governmental bonds. **The hearing will take place on Thursday, May 21, 2009, in the main Committee hearing room, 1100 Longworth House Office Building, beginning at 10:00 a.m.**

Oral testimony at this hearing will be limited to invited witnesses. However, any individual or organization not scheduled for an oral appearance may submit a written statement for consideration by the Committee and for inclusion in the printed record of the hearing.

FOCUS OF THE HEARING:

The hearing will focus on issues relating to tax-exempt and taxable government bonds, and how the issuance of recently authorized taxable bonds may impact the demand for and supply of tax-exempt bonds. Other changes to State and local financing contained in recently passed legislation may also be discussed.

BACKGROUND:

Since the introduction of the Federal income tax, interest income from debt issued by State and local governments has been exempt from tax. The Federal tax exemption lowers the cost of borrowing for State and local governments so that State and local services can be efficiently and consistently provided where they might otherwise not be. State and local borrowing issued as bonds are generally classified either as governmental bonds, which finance governmental functions, or private activity bonds, which provide some benefit to private businesses and may or may not be tax-exempt.

Additionally, other alternative vehicles for State and local government financing have been authorized. For example, tax credit bonds, which allow the holders of such bonds to receive a tax credit instead of an interest payment. Recently, Congress passed H.R. 1, the “American Recovery and Reinvestment Act of 2009,” which was signed into law on February 17, 2009 (Pub. L. 111–5). This Act contains a number of changes impacting State and local government financing, including a new type of taxable government bond named “Build America Bonds.” These bonds allow State and local governments to elect to receive a direct payment from the Federal Government that approximates the subsidy that would have otherwise been delivered through the Federal tax credit for bonds issued in 2009 and 2010. To assist areas impacted by high unemployment, the bill also provides taxable government bonds with a greater subsidy and tax-exempt bonds, named Recovery Zone Economic Development Bonds and Recovery Zone Facility Bonds.

Already, some jurisdictions have issued new bonds under the Build America Bonds program, while the two Recovery Zone Bond programs are awaiting initial Treasury guidance.

In announcing the hearing, Chairman Neal stated, **"As we begin to move this economy forward, Congress should review these innovative financing options for State and local governments as well as the impact on their traditional methods of borrowing. I look forward to hearing the comments from the government issuers as well as from private sector capital market experts."**

DETAILS FOR SUBMISSION OF WRITTEN COMMENTS:

Please Note: Any person(s) and/or organization(s) wishing to submit for the hearing record must follow the appropriate link on the hearing page of the Committee website and complete the informational forms. From the Committee homepage, *http://democrats.waysandmeans.house.gov*, select "*Committee Hearings*." Select the hearing for which you would like to submit, and click on the link entitled, "*Click here to provide a submission for the record*." Once you have followed the online instructions, complete all informational forms and click "submit" on the final page. ***ATTACH*** your submission as a Word or WordPerfect document, in compliance with the formatting requirements listed below, by close of business **Thursday, June 4, 2009**. **Finally**, please note that due to the change in House mail policy, the U.S. Capitol Police will refuse sealed-package deliveries to all House Office Buildings. For questions, or if you encounter technical problems, please call (202) 225–1721.

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1. All submissions and supplementary materials must be provided in Word or WordPerfect format and MUST NOT exceed a total of 10 pages, including attachments. Witnesses and submitters are advised that the Committee relies on electronic submissions for printing the official hearing record.

2. Copies of whole documents submitted as exhibit material will not be accepted for printing. Instead, exhibit material should be referenced and quoted or paraphrased. All exhibit material not meeting these specifications will be maintained in the Committee files for review and use by the Committee.

3. All submissions must include a list of all clients, persons, and/or organizations on whose behalf the witness appears. A supplemental sheet must accompany each submission listing the name, company, address, telephone and fax numbers of each witness.

Note: All Committee advisories and news releases are available on the World Wide Web at *http://democrats.waysandmeans.house.gov*.

The Committee seeks to make its facilities accessible to persons with disabilities. If you are in need of special accommodations, please call 202–225–1721 or 202–226–3411 TDD/TTY in advance of the event (four business days notice is requested). Questions with regard to special accommodation needs in general (including availability of Committee materials in alternative formats) may be directed to the Committee as noted above.

Chairman NEAL. Let me call this meeting to order, and I hope all will take their seats.

Today the Subcommittee will consider Federal tax incentives for State and local financing needs. As a former Mayor of a mid-sized city—I would like to point out, a real Mayor—I personally know the value of tax-exempt financing for community needs.

Our Federal Government has long recognized and acknowledged the important role that cities play in our civilized society. President

Lyndon Johnson put it this way: "The American city should be a collection of communities, where every member has a right to belong. It should be a place where each of us can find the satisfaction and warmth which comes from being a member of the community of man. This is what man sought at the dawn of civilization. It is what we seek today."

The economic downturn has been felt at every level of government, but especially in our cities. The Ways and Means Committee heard from Governors and Mayors at a hearing last October, and responded with a stimulus package, including a number of expansions and improvements for State and local borrowing. Today, we welcome a number of experts to tell us how these bond programs are working, and what remains to be done.

One of my proudest moments as Mayor of the City of Springfield was the largest development ever in the history of western Massachusetts, today known as Monarch Place. As those of you involved in local government know, you scrape together every dollar you can find for these projects from more sources than you care to count. At the heart of these deals is always municipal bonds.

Monarch Place spurred a revival of the downtown, and more bonds were then used for housing and a local theater. It really is a perfect example of how bonds can be utilized to rebuild a community. From roads, bridges, and energy projects, our witnesses will tell us today that Congress is on the right track with some of the new and innovative ways for local governments to build the kind of community that Lyndon Johnson spoke of.

Let me at this moment recognize my friend, Mr. Tiberi, for his opening statement.

Mr. TIBERI. Thank you, Mr. Chairman, and thank you for calling this hearing today. If you would have asked me in 2001, when I got sworn in, that I would be part of a hearing on bonds, I would have thought of major league baseball, and not what we're talking about today, Mr. Chairman. But it is so important.

As we know, the principal ways that State and local governments finance their activities is through issuance of bonds to the public. It's generally agreed that the liquidity crisis and the accompanying economic downturn have made it more difficult for State and local governments to find ways for buyers to buy their bonds.

Indeed, in 2008, total issuances of long-term State and local bonds decreased in comparison to their levels in 2007. It is important that we review this area of the tax law periodically, and it is especially important now, given the state of the economy, and in light of the dramatic changes we have seen in bond programs with the enactment of last year's TARP legislation and this year's stimulus package.

Thank you again, Mr. Chairman. I would like to also thank the witnesses for being here today. We are looking forward to your testimony. I yield back.

Chairman NEAL. Thank you, Mr. Tiberi. Let me welcome our witnesses today.

First, I want to welcome Assistant Secretary for Economic Policy, Alan Krueger. Secretary Krueger was only confirmed by the Senate a few weeks ago, but has kindly agreed to come before us today to discuss this important topic, and we are most appreciative of his time. I also want to thank him for agreeing to be on the panel format today, and allow him, at the right time, to conclude promptly.

I also want to welcome Bob Culver, President and CEO of MassDevelopment in Boston. I worked with Bob for many years, and have always found his comments instructive. I would also point out that he has been most helpful to me in the re-use of the old Federal courthouse in Springfield because we have built a new Federal courthouse in Springfield. And I thought that—the financing, he figured it out, and was right there. So I am indeed grateful for his presence, and we will hear from him shortly, as well.

Let me next welcome Patrick McCoy, the Director of Finance for the Metropolitan Transit Authority of New York. MTA is one of the largest issuers of municipal debt in the country.

Next we will hear from Michael Decker, who is the Co-CEO of the Regional Bond Dealers Association, a trade association which represents security firms active in bond markets. We will also hear from Jim Esposito, a Managing Director at Goldman Sachs, in New York. Mr. Esposito leads the municipal and corporate investment grade new issue financing business at Goldman Sachs.

And finally, we will hear before the Committee from Gary Bornholdt, who served this Committee as a tax advisor to joint tax for many years, and now is a counsel at Nixon Peabody, here in Washington.

We look forward to the testimony that we will hear today, and we want to thank you all for your participation. Without any objection, any other Members wishing to insert statements as part of the record may do so. All written statements by the witnesses will be inserted in the record, as well.

Let me recognize Secretary Krueger for his opening statement.

STATEMENT OF THE HONORABLE ALAN B. KRUEGER, ASSISTANT SECRETARY FOR ECONOMIC POLICY, UNITED STATES DEPARTMENT OF THE TREASURY

Mr. KRUEGER. Thank you. Good morning, Chairman Neal, Ranking Member Tiberi, and other Members of the Subcommittee. I appreciate the chance to appear before you today to discuss changes in Federal tax subsidies to lower borrowing costs for State and local governments and other public agencies.

State and local governments confront difficult challenges in the current economic environment. The American Recovery and Reinvestment Act of 2009 provides a number of new and expanded bond financing subsidies for State and local governments. In general, these bond financing tools will support infrastructure investment, job creation, and economic recovery.

I commend this Committee for its work in leading the successful legislative efforts for these bond financing tools in the Recovery Act.

In my remarks, I will briefly compare the economic effects of different ways of providing a Federal subsidy to reduce State and local borrowing costs with a focus on the broadest new bond program called "Build America Bonds." And, finally, I will highlight the Treasury's efforts to provide prompt guidance for the new bond programs.

There are currently three different ways of providing Federal subsidies to reduce State and local borrowing costs. First, traditional tax-exempt bonds are an important financing tool for State and local governments. There are over $2.7 trillion in outstanding tax-exempt bonds. Tax-exempt bonds lower State and local borrowing costs by making the interest on the bonds tax exempt for investors.

From an economic perspective, however, tax-exempt bonds can be viewed as an inefficient subsidy in that the Federal revenue costs of the tax exemption is often greater than the benefits to State and local governments achieved through lower borrowing costs.

This inefficiency arises because the bonds have a different value to different investors. Investors in higher tax brackets receive a greater tax benefit. The market interest rate of tax-exempt bonds is determined by the tax rate of the marginal investor. The marginal investor is the investor who is just indifferent between buying a tax-exempt bond and buying a taxable bond for another security.

To sell enough bonds, tax-exempt bonds often have marginal investors who are below the highest tax bracket. As a result, tax-exempt bonds tend to give excess benefits to investors in higher tax brackets. This conclusion is consistent with the fact that, since 1986, interest rates on long-term tax-exempt bonds have been about 20 percent lower than the yields on high-grade taxable bonds, whereas the Federal revenue cost has been large enough to finance a 25 to 30-percent reduction in interest rates.

Tax credit bonds are a second way of supporting State and local government borrowing costs. With these bonds, investors receive tax credits for a portion of their borrowing costs. The Recovery Act expands the use of tax credit bonds significantly. Tax credit bonds are more efficient than tax-exempt bonds, in that tax credits have comparable value to all investors with tax liabilities.

The third and most recent innovation in subsidizing State and local government borrowing costs are Build America Bonds. There are two types of Build America Bonds: Tax credit and direct payment.

I will focus on the direct payment Build America Bonds. They are fully taxable to investors, and the Federal Government makes direct payments to issuers equal to 35 percent of the coupon interest.

For example, if a State or local government were to issue Build America Bonds at a 10 percent taxable interest rate, the Treasury Department would make a direct payment to the government of 3.5 percentage points of that interest, and the issuers net borrowing cost would therefore be 6.5 percent.

Direct payment bonds offer four important advantages over traditional tax-exempt bonds. First, they are a fully efficient subsidy. Second, the amount of Federal support to bond issuers can be varied by project type, offering the opportunity to tailor Federal subsidies, to provide different levels of support for different programs. Third, they are potentially attractive to the entire universe of bond investors. And, fourth, the benefits of participating is democratized in that not only those in the highest tax brackets benefit the most.

Because Build America Bonds convey no tax benefits to investors, they have yields comparable to taxable debt instruments, and they should therefore appeal to all bond investors, including pension funds and foreign investors, and investors in lower tax brackets. Expanding the market should result in lower borrowing costs.

The early market reception for Build America Bonds has been very positive, as other Members of this panel can comment. Guidance for Build America Bonds was released in early April of this year. Between mid-April and mid-May, approximately 36 issues of Build America Bonds were made, totaling about $9.5 billion in volume. This represents about 20 percent of the total issuance of tax-exempt bonds during this period. Moreover, investor demand and sales orders for many of the initial issues appears to have been strong.

Preliminary indications suggest that the significant sales volume over the past month may have reduced the supply of tax-exempt bonds somewhat, and possibly contributed to declining interest rates on tax-exempt bonds. It is difficult, however, to separate out the effects of other factors that also influence tax-exempt bond rates.

The Build America Bonds program has just begun. But the early signs are positive. The Treasury will track developments to ascertain whether Build America Bonds can be an effective additional tool to serve the diverse financing needs of State and local governments.

Finally, I want to assure the Committee that the Treasury Department is committed to providing prompt guidance to implement the new bond financing tax incentives. A major part of guidance was issued through five IRS notices released publicly in early April. This guidance implemented the direct payment procedures on the Build America Bond program, and provided volume cap allocation guidance for four additional tax credit bond programs for schools and energy projects.

In the next several weeks, we expect to provide priority guidance on the bond volume cap allocations for the recovery zone bond programs and the Indian tribal economic development bonds. In the coming years, as we move forward beyond the current economic challenges, the Administration is committed to working closely with the Congress to determine how best to provide Federal support for lower borrowing costs to State and local governments in the most efficient, workable, uniform, simple, and sustainable way. Thank you.

[The prepared statement of Mr. Krueger follows:]

Statement by
Alan B. Krueger
Assistant Secretary for Economic Policy and Chief Economist
U. S. Department of the Treasury
before the
Subcommittee on Select Revenue Measures of the Committee on Ways and Means
U.S. House of Representatives
May 21, 2009

Introduction

Good morning Chairman Neal, Ranking Member Tiberi, and other members of the Subcommittee. I appreciate the chance to appear before you today to discuss changes in Federal tax subsidies to lower borrowing costs to State and local governments.

State and local governments confront difficult challenges in the current economic environment. Their residents are losing jobs and consuming less. As a result, States and localities are facing declining tax revenues and having to cut services when more services are needed. The American Recovery and Reinvestment Act of 2009 (the "ARRA") provides a number of new and expanded bond financing subsidies to enable State and local governments to borrow at lower costs for capital projects and targeted programs for schools and energy projects. In general, these bond financing tools aim to promote critical public infrastructure investment, job creation, and economic recovery.

I commend this Committee for its work in leading the successful legislative efforts for these bond financing tools in ARRA.

Tax-preferred bonds, particularly tax-exempt bonds, are an important source of financing for State and local government infrastructure projects and other significant public activities. There are over $2.7 trillion in outstanding tax-exempt bonds. State and local governments have issued an average of about $340 billion of tax-exempt governmental bonds annually in the past five years (plus an average of about $30 billion annually in tax-exempt "private activity bonds" for the benefit of private entities subject to annual volume caps).

In my testimony, I will discuss several aspects of these State and local governmental bond programs. First, I will compare the different ways of providing Federal subsidies for State and local government borrowing. Second, I will focus on the broadest new bond program, called "Build America Bonds," and its early market reception. Third, I will touch briefly on the Recovery Zone Bond program aimed at areas hard-hit by unemployment and the tax credit bond programs for schools and energy. Finally, I will highlight Treasury Department's efforts to provide prompt guidance to implement these bond programs.

Different Ways to Deliver a Federal Subsidy to State or Local Governments for Lower Borrowing Costs.

First, I want to compare three general approaches to subsidizing State and local government borrowing that are provided for under current law: (1) traditional tax-exempt bonds; (2) bonds for which tax credits pay a portion of borrower interest costs; and (3) bonds for which direct payments are made to the issuer to subsidize interest payments.

Traditional Tax-exempt Bonds: Tax-exempt Interest to Investors

Tax-exempt bonds deliver an indirect subsidy for State and local government borrowing. Because the interest paid is exempt from investors' taxable income under Section 103 of the Internal Revenue Code ("Code"), investors are willing to accept lower interest rates on tax-exempt bonds than on conventional taxable bonds.

Tax-exempt bonds are an inefficient means of subsidizing State and local borrowing if the Federal revenue cost of tax-exempt bonds exceeds the benefit provided to State and local governments. This would occur if, in order to clear the market, interest rates on tax-exempt bonds are set high enough to attract investors below the top Federal marginal tax rate bracket. The interest rate paid in that event is such that investors with the lowest marginal tax rate among buyers receive the same after-tax return on tax-exempt bonds as they do on taxed bonds. For those so-called marginal investors, the value of the tax exemption is equal to the interest subsidy paid to State and local governments. But investors with marginal tax rates higher than that of the marginal investor would receive tax subsidies larger than the interest subsidy conveyed to the borrower. As a result, in this example, it costs the Federal government more than $1 to give State and local governments a $1 subsidy in terms of lower interest rates. This appears to be a common occurrence. As evidence, since 1986 interest rates on long-term tax-exempt bonds have been about 20 percent lower than the yields on high-grade taxable bonds whereas the Federal revenue cost has been large enough to finance a 25 to 30 percent reduction of interest rates.

"Tax Credit Bonds": Federal Tax Credits to Investors in Lieu of Interest

"Tax credit bonds" are potentially more efficient than tax exempt bonds for delivering a Federal subsidy to state or local governments with respect to their borrowing costs. Investors in new tax credit bonds provided for in ARRA receive a Federal tax credit equal to a set percent of interest received. The tax credit provides investors with a subsidy just sufficient to make them indifferent between the tax credit bond and an otherwise similar taxed bond. As a result, each dollar of Federal revenue foregone therefore benefits State and local governments by a dollar.

The potential market for tax credit bonds is broader than for tax-exempt bonds. Potential buyers of tax credit bonds include anyone with Federal tax liabilities at least as large as the tax credits the bonds convey. This includes many taxpayers with marginal tax rates below the level that makes tax-exempt bonds a profitable purchase. A recent 2008 statutory change in Code Section 54A(i) authorizes the Treasury Department to adopt regulations that enlarge the market still further by allowing separation or "stripping" of tax credits from tax credit bonds and the sale of the bond cash flow and tax credits separately to different investors. This stripping provision may expand the market for tax credit bonds to include a broader set of investors than traditionally participate in the tax-exempt bond market. For example, entities without tax liabilities could purchase the bonds and sell the stripped tax credits.

At the same time, the potential market for tax credit bonds is limited in a way similar to tax-exempt bonds in that they also are tax-advantaged investments that compete with other tax-advantaged investments. Recent economic conditions and associated uncertainty have limited the demand for tax-advantaged investments further. Moreover, until this year, the total Congressional authorization for tax credit bonds was very limited (mainly, $400 million annually for qualified zone academy bonds since 1998 and some energy bonds beginning in 2006). As a result, the market for tax credit bonds has remained small, illiquid, and undeveloped.

Build America Bonds Providing Direct Federal Subsidy Payments to State and Local Governments

A third way to deliver a Federal subsidy to State and local governments to reduce their borrowing costs would be to make direct Federal subsidy payments to such State and local governments. Build America Bonds represent the first program that implements such a strategy.[1] Build America Bonds are similar to tax credit bonds, but the credit is paid directly to State and local governments rather than to investors. They are taxable bonds with "refundable tax credits" in which the Federal government makes direct subsidy payments to State and local governments for a portion of their borrowing costs.

Like tax credit bonds, Build America bonds that provide a direct subsidy are efficient—each dollar of revenue foregone by the Federal government benefits State and local governments by a dollar.

Because investors receive no direct tax benefits, these bonds will have yields comparable to taxable debt instruments and should be attractive to investors irrespective of their tax status or income tax bracket (such as pension funds and other tax-exempt investors, investors in lower tax brackets, and foreign investors). Therefore, direct Federal subsidy payment bonds should appeal to a broader market than either traditional tax-exempt bonds or tax credit bonds and thereby provide lower State and local governmental borrowing costs.

[1] As is explained in the next section, there are two types of Build America Bonds—one type that pays direct subsidies to State and local governments, and the other type that is structured like a tax credit bond. This testimony refers to the first type as simply "Build America Bonds," and the second type as "Tax Credit Build America Bonds."

Differences in "Depth" of Federal Subsidy

One flexible aspect of direct Federal subsidy payment bonds and tax credit bonds is that these subsidies can be tailored to provide different levels of Federal support by adjusting the subsidy rate. The existing direct Federal subsidy payment programs and tax credit bond programs under current law reflect different subsidy rates for different programs.

Build America Bonds

Build America Bonds under new Code Section 54AA are the broadest and most innovative new bond financing tool for State and local governments included in ARRA.

There are two types of Build America Bonds. The first type, herein referred to as "Tax Credit Build America Bonds," provides a Federal subsidy for State and local governmental borrowing costs in the form of a Federal tax credit to investors for a portion of the coupon interest (excluding original issue discount) payable on the bonds similar to other tax credit bonds discussed herein. Tax Credit Build America Bonds can be issued to finance the same kinds of expenditures (e.g., capital expenditures and working capital expenditures) and may involve the same kinds of financings (e.g., original new money financings, current refundings, and one advance refunding) as tax-exempt governmental bonds (excluding private activity bonds under Code Section 141).

As noted above, the second type of Build America Bond provides direct subsidy payments to State and local governments. The subsidy payments equal 35 percent of the coupon interest (excluding original issue discount) on the bonds payable contemporaneously with debt service payments. For example, if a state or local government were to issue Build America Bonds at a 10 percent taxable interest rate, the Treasury Department would make a payment directly to the government of 3.5 percentage points of that interest, and the issuer's net borrowing cost would thus be only 6.5 percent.

The Federal subsidy of 35 percent of the coupon interest on Build America Bonds is "deeper" than the implicit Federal subsidy for traditional tax-exempt bonds, where the tax exemption typically results in about a 20 percent reduction in interest rates.

Program Parameters

Build America Bonds can be issued by State and local governments during 2009 and 2010 to finance capital expenditures for the full range of capital project types for which they are eligible to issue traditional tax-exempt governmental bonds (excluding private activity bonds under Code Section 141). The range of capital projects includes, without limitation, public buildings, courthouses, schools, roads, bridges, public transit, transportation infrastructure projects, governmental hospitals, public safety facilities and equipment, water and sewer projects, environmental projects, energy projects, governmental housing projects, public utilities, and any other capital projects that are used primarily for state or local governmental use or payable primarily from governmental funds.

Build America Bonds are available for "new money" financings to encourage new investments in public infrastructure, as contrasted with refinancings for existing capital projects. Build America Bonds also may be used to reimburse capital expenditures made out of pocket or to refinance certain temporary financings for capital costs paid or incurred after the effective date of the 2009 tax legislation.

There is no volume cap on the amount of Build America Bonds that State and local governments can issue during 2009 and 2010. Build America Bonds cannot be issued with more than a *de minimis* amount of premium determined under rules similar to Code Section 1273(a)(3). The arbitrage investment restrictions under Code Section 148 apply in a tailored manner adopted to Build America Bonds.

Notably, there is a permanent, indefinite appropriation for the direct Federal subsidy payments on Build America Bonds under 31 U.S.C. Section 1324(b)(2) comparable to the permanent, indefinite appropriation authorizing the Treasury Department to make outlays that refund overpayments of tax of certain programs conducted through the tax code.

Early Market Reception for Build America Bonds.

The early market reception for Build America Bonds has been very positive. Based on reported data, between April 15 and May 20, 2009, approximately $9.5 billion in dollar volume and approximately 36 bond issues of Build America Bonds were issued since the first public sale in mid-April, which represents about 20 percent as large as the issuance of tax-exempt bonds during this same period.[2] Investor demand and sales orders for many of the initial transactions of Build America Bonds exceeded the available supply offered in the market.

The state of California sold a benchmark issue of Build America Bonds on April 22, 2009 in a principal amount of about $5.23 billion. This transaction was oversubscribed with about $16 billion in orders. In this transaction, about 97 percent of investors were institutional investors and about 90 percent of investors were domestic investors.[3]

As discussed above, the deeper Federal subsidies for Build America Bonds potentially offer significant savings to State and local governments as compared with traditional tax-exempt bonds. In the initial issuances of Build America Bonds, estimates of issuer savings over traditional tax-exempt bonds ranged from 40 to 60 basis points for issuances in the first week following the initial issuance to over 100 basis points more recently.[4]

[2] Source: Thomson Financial.
[3] Source: Barclays Capital.
[4] Ibid.

Collateral Impact on Supply Potentially Lowers Tax-exempt Bond Rates

Build America Bonds are an additional State and local governments financing option that are intended to supplement, not replace, traditional tax-exempt bonds. One purpose of the new Build America Bond program is to reduce supply pressures in the traditional tax-exempt bond market through a new financing option that provides subsidized financing for State and local governments, but that can be readily sold into broader bond markets. The supply relief from the Build America Bond program should help to stabilize the tax-exempt bond market and to provide relief to State and local governments which are facing significant pressures in the current environment.

Preliminary indications suggest that the significant volume of early sales of Build America Bonds over the past month may have provided some relief to supply in the tax-exempt bond market and contributed to declining interest rates in the tax-exempt bond market. It is difficult, however, to separate out the effect of other factors that influence tax-exempt bond rates.

Comment on Market Impact, Future Prospects, and Administrative Challenges

The Build America Bond program has just begun. While it is premature to make any general statements about the program or its future prospects, the early signs are positive. The Build America Bond program offers potential for a broader and more efficient market for at least some portion of the State and local governmental debt sector as compared to the traditional tax-exempt bond market.

It is uncertain the extent to which Build America Bonds can serve the diverse financing needs of State and local governments. Characteristics of the conventional corporate taxable bond market generally include large, well-known issuers with investment grade credits, large minimum issue sizes of about $250 million, institutional purchasers, and bond structures involving bullet maturities with "make-whole" calls. By comparison, the traditional tax-exempt bond market includes over 50,000 State and local government issuers, large numbers of bond issues (about 10,000 to 15,000 issues annually), small average size of bond issues (about $25 million), retail purchasers, and bond structures involving serial bonds and 10-year optional par calls.

One major administrative challenge for the Treasury Department and the IRS is serving effectively as paying agents for a significant portion of the State and local governmental bond market. The recurring Federal direct subsidy payments to State and local governments for Build America Bonds will require development of an efficient electronic payment system and tax compliance safeguards. Finally, because Build America Bonds treat the Federal subsidy payments to State and local governments akin to tax refund payments, this treatment will require development of new tax compliance procedures.

A tax policy goal will be to move in the direction of simpler and more uniform programs for providing Federal subsidies for State and local governmental borrowing costs in efficient ways that afford broad market access to State and local governments.

Other Targeted Bond Program Tax Incentives in the 2009 Tax Legislation

Next, I want to mention briefly a number of other targeted bond program tax incentives under ARRA.

Recovery Zone Bonds

ARRA provides a $25 billion authorization for two types of Recovery Zone Bonds targeted to areas hard-hit by unemployment in 2008.

A $10 billion authorization for Recovery Zone Economic Development Bonds involves a type of direct payment Build America Bond with a deeper Federal subsidy payment equal to 45 percent of the interest on the bonds for governmental use for a broad range of qualified economic development purposes in recovery zones.

A $15 billion authorization for Recovery Zone Facility Bonds involves a type of traditional tax-exempt bond which may be used by private businesses to finance depreciable capital projects for original use in active businesses in recovery zones, excluding residential rental housing.

Tax Credit Bond Programs for Schools and Energy

ARRA provides new or expanded authorizations for four targeted tax credit bond programs for schools and energy under national volume caps that are allocated based on statutory criteria that are unique to each program. These bond programs include:

(1) Qualified School Construction Bonds. A $22.4 billion authorization for 2009-2010 for Qualified School Construction Bonds, which provide a Federal subsidy in the form of tax credits to investors for 100 percent of the borrowing costs on tax credit bonds used for public school construction.

(2) Qualified Zone Academy Bonds. A $2.8 billion authorization for 2009-2010 for Qualified Zone Academy Bonds, which provide a Federal subsidy in the form of tax credits to investors for 100 percent of the borrowing costs on tax credit bonds used for public school renovation, repair, course materials, and teacher training.

(3) Qualified Energy Conservation Bonds. A $3.2 billion authorization for Qualified Energy Conservation Bonds, which provide a Federal subsidy in the form of tax credits to investors for 70 percent of the borrowing costs on tax credit bonds used for a broad range of qualified energy conservation purposes.

(4) New Clean Renewable Energy Bonds. A $2.4 billion authorization for New Clean Renewable Energy Bonds, which provide a Federal subsidy in the form of

tax credits to investors for 70 percent of the borrowing costs on tax credit bonds used for a broad range of clean renewable energy projects.

In the current market, the demand for tax credits is limited and uncertain, and the issuance of these recently-authorized tax credit bonds has been very limited in 2009. One notable recent issue of tax credit bonds involved a $38.84 million issue of Qualified School Construction Bonds for the San Diego Unified School District on April 21, 2009.

Tax Incentives to Assist with Demand for Tax-exempt Bonds in 2009 Tax Act

I also want to mention several provisions in ARRA that aim at improving demand in the tax-exempt bond market.

A new temporary two percent *de minimis* bank purchase exception and an expanded $30 million small issuer bank purchase exception to the Code Section 265(b) tax-exempt carrying cost disallowance rules applicable to financial institutions encourage banks to purchase tax-exempt bonds issued in 2009 and 2010.

In addition, a temporary repeal of the alternative minimum tax preference on certain tax-exempt private activity bonds encourages purchases of these bonds in 2009 and 2010.

The Treasury Department's Priority Efforts on Prompt Implementing and Reporting Guidance

Before concluding, I want to highlight the Treasury Department's commitment to provide prompt guidance to implement the new bond financing tax incentives so that State and local governments can use these tools for public infrastructure and economic recovery, as well as the Department's commitment to report on those benefits.

Early April Implementing Guidance

A major part of guidance was issued through five IRS Notices released publicly on April 3, 2009 and April 6, 2009. This guidance implemented the direct payment procedures on the Build America Bond program and provided volume cap allocation guidance on each of four targeted tax credit bond programs for schools and energy (including Qualified School Construction Bonds, Qualified Zone Academy Bonds, Qualified Energy Conservation Bonds, and New Clean Renewable Energy Bonds). Set forth below are references to early April guidance and citations to where it can be found in the Internal Revenue Bulletin.

Build America Bonds--Notice 2009-26, 2009-16 I.R.B. 833 (April 20, 2009). This guidance covers the direct Federal subsidy payment procedures regarding the following:

- how (on new IRS Form 8038-CP available now) and when (by 45 days before an interest payment date) to request these payments;
- when the IRS will begin making these payments (July 1, 2009);

- how to make necessary elections to issue these bonds (in writing in an issuer's books and records);
- how to satisfy the information reporting requirement for these bonds (modified IRS Form 8038-G);
- future implementation plans (electronic platform in 2010); and
- a solicitation of public comment on all aspects of this program.

Qualified School Construction Bonds--Notice 2009-35, 2009-17 I.R.B. 876 (April 27, 2009).
Qualified Zone Academy Bonds. Notice 2009-30, 2009-16 I.R.B. 852 (April 20, 2009).
Qualified Energy Conservation Bonds. Notice 2009-29, 2009-16 I.R.B. 849 April 20, 2009).
New Clean Renewable Energy Bonds. Notice 2009-33, 2009-17 I.R.B. 865 April 27, 2009).

Near-Term Priority Guidance on Recovery Zone Bond Allocations

In the next several weeks, we expect to provide priority guidance on the bond volume cap allocations for the $25 billion Recovery Zone Bond programs. The Bureau of Labor Statistics released unemployment data needed for this purpose in mid-April 2009.

The Treasury Department wants to encourage use of Recovery Zone Bonds and to make this program as administratively easy as possible for State and local governments.

Near-Term Priority Guidance on Indian Tribal Economic Development Bond Allocations

Also in the next several weeks, we expect to provide priority guidance on the bond volume cap allocation process for the $2 billion authorization for Indian Tribal Economic Development Bonds. We solicited public comment on this program. We are consulting with the Department of the Interior on this matter.

Future Priority Guidance on "Stripping" of Tax Credit Bonds

We also have a longer-term priority project to provide guidance on "stripping" of tax credits to broaden the investor market for tax credit bonds. This project will require careful consideration of accounting rules for tracking tax credits and appropriate tax compliance safeguards.

Reporting

The ARRA brings with it an unprecedented commitment to transparency and accountability in the application of taxpayer resources. To meet these high standards, Treasury and IRS are undertaking an extraordinary effort to provide data to the public on the benefits these bond programs deliver to the American people.

Conclusion

The Administration recognizes that tax-preferred bond financing plays an important role as a financing source for State and local governments and public agencies to provide for public infrastructure projects and other significant public purposes, which will help create and save jobs and expand our economy. In the coming years as we move forward beyond the current economic challenges, the Administration is committed to working closely with the Congress to determine how best to provide Federal subsidies for lower borrowing costs to State and local governments in the most efficient, workable, uniform, simple, and sustainable way possible.

Chairman NEAL. Thank you, Mr. Krueger.
Mr. Culver.

STATEMENT OF ROBERT L. CULVER, PRESIDENT AND CHIEF EXECUTIVE OFFICER, MASSDEVELOPMENT, BOSTON, MASSACHUSETTS

Mr. CULVER. Chairman Neal, Ranking Member Tiberi, Members of the Committee, thank you for inviting me to testify, and for holding this hearing. I cannot overstate the importance of the American Recovery and Reinvestment Act of 2009, but would suggest that more can be done to maximize its impact.

I am Bob Culver, President and CEO of the Massachusetts Development Finance Agency, a quasi-public finance and development entity in the Commonwealth of Massachusetts. Having issued private activity bonds that generated more than $2 billion in investment in Massachusetts last year, MassDevelopment knows this market, which aids affordable housing, higher education, manufacturing, and waste recovery.

I speak this morning as a representative of my agency, only. I have submitted a written statement to the Committee from which I will summarize six main topics. I call your attention to two themes that run through my testimony. First, standardizing allocation processes using the well-vetted and understood volume cap method as a model. And, second, extending allocations of special issuance capacity, and making permanent enhancements to eligibility to allow more borrowers to use these programs.

Briefly, the first of the six subjects I would like to touch on concerns the expanded definition of manufacturing facilities for qualified manufacturing bonds, to include the production of intangible properties, such as software. ARRA also eliminated the 25 percent limit on directly related and ancillary property. Both of these provisions expire in 2011. These enhancements are key to supporting modern manufacturing facilities, thereby expanding the economy.

However, many companies will not use them today, but will need them as the economy rebounds. MassDevelopment supports making these enhancements permanent to bring manufacturing bonds into the 21st century.

Second, ARRA creates recovery zone facility bonds, a new PAB category with a national limit of $15 billion. Uses include acquisition and construction of property in designated recovery zones. The provision expires on December 31, 2011. After Treasury allocates cap amounts, each State must implement a process and identify projects. And large scale redevelopment projects may take more than a year to be ready for permanent financing.

To maximize this program's potential, MassDevelopment urges Treasury to give State governments control of allocating issuance capacity among eligible projects, and asks Congress to allow unexpended capacity to be carried forward through 2015.

Third, ARRA increased the national issuance capacity for clean renewable energy bonds, but reduced the allowable tax credit. Issuance capacity is awarded by the IRS, and favors smaller issues over larger, less costly ones. MassDevelopment used its entire allocation in 2006 to support 12 solar projects at State facilities, but may not be able to do so again because of the constrained tax credit market and reduced tax credit.

Giving States a pro-rata share of the overall issuance capacity and the ability to select projects could save time and money. Giving the program a direct pay option from the Federal Government could speed use of the program and deliver more benefits by eliminating structuring costs.

Fourth, ARRA increases the issuance capacity of qualified energy conservation bonds. These bonds are also dependent on a vibrant tax credit market. Giving States control over where to allocate issuance capacity could enhance the program. And because these projects take years to advance, unused issuance capacity should be carried forward to 2015.

While MassDevelopment applauds Congress for providing this option, creating a new category of private equity activity, tax-exempt facility bonds would give renewable energy developers the certainty of a permanent Tax Code provision.

Next, ARRA increases the bank-qualified bond provisions to apply to issuers of less than $30 million a year, and include 501(c)(3)'s that borrow through a conduit issuer like MassDevelopment. This provision will increase the market for tax-exempt bonds by enlisting more banks as potential purchasers, while allowing them to pass through lower interest rates.

MassDevelopment supports these provisions, but recommends eliminating the 2011 expiration date, and extending them to other types of private activity bonds, in particular manufacturing.

Finally, in 2008 Congress authorized the Federal home loan banks to confirm bank-issued letters of credit on tax-exempt private activity bonds beyond affordable housing. This levels the playing field for smaller and mid-sized banks to support tax-exempt bonds, and helps offset the collapse of bond issuers and credit ratings of some larger banks. We support this program, and recommend it be made permanent, so that a market can develop. It comes with no significant cost to the Federal Government, makes the market more efficient, and puts more banks to work.

I appreciate the opportunity to speak to the Committee, and look forward to your questions. Thank you, Mr. Chairman.

[The prepared statement of Mr. Culver follows:]

Prepared Statement of Robert L. Culver, President and Chief Executive Officer, MassDevelopment, Boston, Massachusetts

Chairman Neal, Ranking Member Tiberi, Members of the Committee: Thank you for inviting me to testify before you this morning and for holding this hearing. One cannot overstate the importance of the American Recovery and Reinvestment Act of 2009, but more can be done to maximize the impact of ARRA.

I am President and CEO of the Massachusetts Development Finance Agency (MassDevelopment), a quasi-public finance and development entity established by the Legislature in the Commonwealth of Massachusetts. Having issued private activity bonds that generated more than $2 billion in investment in Massachusetts in fiscal year 2008, MassDevelopment knows this market, which aids affordable housing, higher education, manufacturing, and waste recovery.

I speak this morning as a representative of my agency, only.

In particular, I call your attention to two general themes that run through my testimony:

- First, standardize allocation processes using the already well-vetted and well-understood volume cap method as a model, and

- Second, extend allocations of special issuance capacity and make permanent certain enhancements to eligibility to allow more borrowers to take advantage of these programs.

Expanded Definition of Manufacturing Facility

The first topic that I want to address has to do with ARRA's expansion of the definition of manufacturing facilities for qualified manufacturing bonds to include facilities used in the production of intangible property such as software and biotech. ARRA also eliminates the 25% limit on directly related and ancillary property so that such property may be financed if it is functionally related and subordinate to the manufacturing facility. Both of these provisions expire on January 1, 2011.

These enhancements are important to supporting modern manufacturing and production facilities, and expanding the economy. Crucially, these bonds are subject to States' annual allocations of volume cap, which was not expanded. For that reason, the expansions of the applications should not be seen as an additional cost to the government. Notably, many manufacturing companies will not take advantage of these provisions in the current economic climate but will need them for expansions as the economy rebounds. MassDevelopment strongly supports making these enhancements permanent to bring manufacturing bonds into the 21st century.

Recovery Zone Facility Bonds

Second, ARRA creates Recovery Zone Facility Bonds, a new category of tax-exempt private activity bonds subject to a national limit of $15 billion. Eligible uses include acquisition and construction of property in designated Recovery Zones.

As of the writing of this testimony, guidance from the U.S. Department of the Treasury has not yet been released on how the cap would be allocated among the States. After guidance is issued, further work must be done in each State to implement the allocation process and identify projects. While the interest rate savings on a tax-exempt bond is not enough of a subsidy to make or break large-scale projects, the savings can still be useful in steering development to underserved areas. These types of projects may take more than a year to be ready for permanent financing, which means that the December 31, 2010 expiration date may prove problematic.

To maximize the potential of this new bond program, MassDevelopment urges Treasury to give State governments control of allocating issuance capacity among eligible projects and asks Congress to provide for the carrying forward of unexpended issuance capacity for 5 years beyond December 31, 2010.

Clean Renewable Energy Bonds

Third, ARRA increased the national issuance capacity for clean renewable energy bonds, which are tax-credit bonds that governmental entities can use to finance eligible renewable energy projects.

These bonds are dependent on a vibrant tax credit market that does not exist at this time. This concern is exacerbated because the expanded program is limited to 70% of the tax credit allowed by the original program. The issuance capacity is awarded to governmental borrowers by the Internal Revenue Service by ranking applications from smallest to largest. This approach favors small issues that tend to be less efficient than larger ones because of the proportionately larger cost of issuance.

MassDevelopment used its entire allocation in 2006 to support 12 solar projects at State facilities. We are concerned, however, that we may not be able to use the program as successfully again because of the constrained tax-credit market and the reduced tax credit. The potential of the program would be greatly enhanced by giving States a pro-rata share of the overall issuance capacity along with the ability to select projects, rather than leaving the application process with the IRS, which takes more time and favors less efficient projects.

We would also favor giving the program a "direct pay" option from the Federal Government (as with Build America Bonds) instead of tax credits. Doing so would speed the use of the program and possibly deliver more benefits to the projects by eliminating some of the structuring costs and investor yield requirements.

Qualified Energy Conservation Bonds

Fourth, ARRA increases the issuance capacity for Qualified Energy Conservation Bonds. These are tax-credit bonds that can be used for both governmental and private purposes and can finance a broad range of energy conservation and renewable energy generation projects.

MassDevelopment fully supports the objectives of this program. Like the Clean Renewable Energy Bonds, however, the energy conservation bonds are dependent on a vibrant tax credit market. In line with our prior recommendation for the Recovery Zone Facility Bond program, to enhance the program's health States should have control over where to allocate issuance capacity. And unused issuance capacity should be able to be carried forward to 2015.

While MassDevelopment applauds the Congress for making tax-advantaged financing available for renewable energy projects, an efficient way to support this sector would be to create a new category of private activity, tax-exempt facility bonds. Doing so would allow the sector to benefit from the same tax-exempt bonding programs currently available to waste recovery projects. This new category would also give renewable energy developers the certainty of a permanent provision of the Tax Code. These projects—which involve financing, permitting, and site-control issues—take years to advance, a process that could be short-circuited if the necessary incentives expire in the short term without certainty of renewal.

Bank Deductibility of Interest Expense

Next, ARRA increases the "bank-qualified" bond provisions to apply to issuers of less than $30 million per year, up from $10 million per year, and to include 501(c)3 borrowers that borrow through a conduit issuer such as MassDevelopment.

This provision will increase the market for tax-exempt bonds by enlisting more banks as potential purchasers while allowing them to pass through lower interest rates. MassDevelopment places many of its smaller issues directly with banks, which handle the transactions much like commercial loans. These borrowings benefit from the discipline of having a bank lender instead of the capital markets and also from having smaller costs of issuance.

MassDevelopment supports the increased bank-qualified provisions, but recommends that they be extended to other types of private activity bonds other than 501(c)3 borrowings, in particular manufacturing. The Agency also recommends eliminating the expiration date of 2011.

Federal Home Loan Bank Confirming Letters of Credit

Finally, in 2008, Congress authorized the Federal Home Loan Banks to confirm bank-issued letters of credit on tax-exempt private activity bonds beyond affordable housing only. This authorization will be tremendously useful in providing investment grade rated credit to guarantee private activity bonds issued by conduit issuers such as MassDevelopment. This authorization levels the playing field for smaller and mid-sized banks to support tax exempt bonds, and helps to offset the collapse of bond insurers and the investment grade credit ratings of some of the larger banks.

We fully support this program and recommend that it be made permanent beyond 2010 so that a market can develop. MassDevelopment believes this program comes with no significant cost to the Federal Government: The program does not increase the eligible uses of tax-exempt bonds, but simply makes the market more efficient and puts more banks to work. In fact, MassDevelopment recently held seminars across Massachusetts that banks enthusiastically attended. Our agency closed its first issue under this expanded capacity in March.

Thank you for the opportunity to submit this testimony.

Chairman NEAL. Thank you, Mr. Culver.

Mr. McCoy.

STATEMENT OF PATRICK J. MCCOY, DIRECTOR OF FINANCE, NYS METROPOLITAN TRANSPORTATION AUTHORITY, NEW YORK, NEW YORK

Mr. MCCOY. Good morning, Mr. Chairman, Ranking Member Tiberi, and Members of the Subcommittee. I want to thank you for the opportunity to testify today on taxable and tax-exempt municipal government bonds and, in particular, the newly created Build America Bonds program.

Mr. Chairman, as you know, the MTA transportation network is one of the largest in the world. MTA provides 8.7 million subway, bus and commuter railroad rides daily, or 2.7 billion rides per year, accounting for nearly one-third of all transit riders in the United States. MTA also operates seven bridges and two tunnels that carry nearly 300 million vehicles per year, the most heavily trafficked bridge and tunnel system in the Nation. MTA accomplishes this mission with over 69,000 dedicated employees.

Investment in this vast regional transportation network has resulted in MTA being one of the largest issuers of municipal debt in the United States, with over $26 billion in debt outstanding at this time.

Since 1982, MTA has invested over $72 billion in capital improvements through a series of 5-year capital programs that are funded from city, State, and Federal grants, as well as our bond financing program. MTA has replaced or overhauled nearly the entire system, including restoration of Grand Central Terminal, and Long Island Railroad's Penn Station.

The need to maintain our extensive transportation infrastructure and keep it in a state of good repair requires stable and predictable capital investment. But dramatic ridership growth over the past 10 years, nearly 50 percent across the board, has also required us to undertake the first major expansion of our service in over 60 years through the construction of the Second Avenue Subway, Number Seven Line extension, and connecting Long Island Railroad with Grand Central Terminal.

Our existing current 2005 through 2009 capital program, which covers both maintenance and state-of-good-repair investment, as well as expansion needs, is over $22 billion.

Like many other issuers, MTA uses a variety of funding sources to meet its capital program requirements, including bond financing, which accounts for about 40 percent of our current capital funding needs. Bond financing for large capital expenditures matches the funding of the asset with the useful life of the asset. If a subway car, for example, lasts for 30 years, we like to finance that with a 30-year debt.

MTA is slated to issue roughly $2 billion per year in the foreseeable future to continue these investments, just our bond financing portion of the funding.

The ongoing global credit crisis has had a devastating effect on the municipal bond market over the past year, and that has hampered State and local governments across the country from being able to access the market affordably. For example, State and local governments, including the MTA, have seen their access to liquidity severely constrained at increasing cost. This is a trend that appears to be continuing for the foreseeable future.

While, however, it does appear, though, that the credit markets are slowly recovering, ensuring long-term stability should be a vital priority for Congress and the Administration.

One of the more positive developments that has taken hold of the market this year are the many bond provisions that were included in the American Recovery and Reinvestment Act of 2009, especially the newly created Build America Bonds program. We were one of the first issuers to take advantage of this program, and I would like to talk a little bit about that now.

In April, we announced plans to issue $200 million in Build America Bonds under our dedicated tax fund rated AA by S&P and A+ by Fitch. We plan to enter the market at the same time, with $400 million in tax-exempt bonds. And, as you know, these markets that we issue into, the taxable and the tax-exempt markets, are different, and they are structured and priced differently.

Traditional tax-exempt bonds are structured with serial maturities, or with part of the principal amount due each year, much like a mortgage. And often there are larger maturities, referred to as term bonds, at the end of the amortization schedule, similar to a balloon payment on a mortgage. Serial and term bond structure allows the issuer to repay part of the principal and interest each year until the bond is repaid. Traditional tax-exempt bonds are generally priced relative to an index of AAA-rated municipal bonds.

Tax credit bonds, including Build America Bonds, generally need to be issued with long-dated, bullet maturities, which are common in the corporate taxable bond market. In other words, the entire principal amount would be due in one lump-sum payment. Build America Bonds are—like corporate taxable bonds—priced relative to the 30-year Treasury, and we express that as a spread to Treasuries. MTA was optimistic that this structure would expand the pool of investors, increase market access for our debt.

Other issuers that came the same week as the MTA were the State of California and the New Jersey Turnpike. We all priced our bonds on different days, and we watched how these other issuers came to market and worked aggressively to price our bonds as efficiently as possible at that time. Our initial offer of $200 million was increased to $750 million, due to very strong investor interest at the time of the issue.

I will sum up now. The Build America Bond program has expanded the investor base for municipal bonds. And there were approximately 35 new investors that came into the MTA deal that had never participated in our borrowings before. By attracting these new investors, MTA was able to expand and diversify the investor base, which we believe will help achieve more efficient pricings in the future.

The rest of my testimony is on record, and I will be happy to take questions at that time, after concluding. Thank you.

[The prepared statement of Mr. McCoy follows:]

Statement of Patrick J. McCoy
Director of Finance
NYS Metropolitan Transportation Authority
Testimony before the Subcommittee on Select Revenue Measures
of the House Committee on Ways and Means

May 21, 2009

Good Morning Mr. Chairman, Ranking Member Tiberi and Members of the Subcommittee. I want to thank you for the opportunity to testify today on taxable and tax-exempt municipal government bonds, and in particular the newly created Build America Bonds program.

Mr. Chairman, as you may know, the MTA transportation network is one of the largest in the world. The MTA provides 8.7 million subway, bus and commuter railroad rides daily – or 2.7 billion rides each year, accounting for nearly one third of all transit riders in the United States. The MTA also operates seven bridges and two tunnels that carry nearly 300 million vehicles per year – the most heavily trafficked bridge and tunnel system in the nation. The MTA accomplishes this mission with over 69,000 dedicated employees.

Investment in this vast regional transportation network has resulted in the MTA being one of the five largest issuers of municipal debt in the U.S., with over $26 billion in debt outstanding.

Mr. Chairman, City, State and Local governments issue municipal debt to fund infrastructure, capital improvements and to maintain a state of good repair for assets with long lives such as transportation infrastructure. For example, since 1982 the MTA has invested over $72 billion in capital improvements through a series of five-year capital programs that are funded from City/State/Federal grants and bond financing. The MTA has replaced or overhauled nearly all of the subway, railroad, and bus fleets; rebuilt maintenance shops and much of the 2,000 miles of subway and railroad track; rehabilitated scores of subway and railroad stations; and restored Grand Central Terminal and the Long Island Rail Road's Penn Station.

The need to maintain our extensive and aging transportation infrastructure and to keep it in a state of good repair requires stable and predictable on-going capital investment. But dramatic ridership growth over the last ten years – nearly 50% across the board – has also required us to undertake the first major expansion of our service in over sixty years through the construction of the Second Avenue Subway, extension of the Number Seven Line and connecting Long Island Rail Road to Grand Central Terminal. Accordingly, our current 2005-2009 plan, which covers both maintenance and expansion needs, totals $22.5 billion.

Like many other municipalities, the MTA uses a variety of funding sources to meet its capital program requirements, including bond financing which accounts for about 40% of MTA's current capital funding needs. Bond financing for large capital expenditures matches the funding of the asset with the useful life of that asset. In other words, long term financing for assets with long lives. In that regard, the MTA is slated to issue roughly $2.0 billion per year to fund the capital program.

The ongoing global credit crisis has had a devastating effect on the municipal bond market over the past year, and that has hampered state and local governments across the country from being able to access the market affordably. For example, state and local governments have seen their access to liquidity severely constrained at increasing costs – this is a trend that appears to be continuing for the foreseeable future. While it appears as though the credit markets are slowly recovering, ensuring long term stability should be a vital priority for Congress and the Administration.

One of the more positive developments that has taken hold of the market this year are the many bond provisions that were included in the American Recovery and Reinvestment Act of 2009, especially the newly created Build America Bonds program. We were one of first issuers to take advantage of this program.

Mr. Chairman, I would like to take this opportunity to share our experience with the Build America Bonds program with you and the subcommittee.

In April, the MTA announced its plan to offer $200 million in Build America Bonds under our Dedicated Tax Fund resolution which is rated "AA" by Standard and Poor's and "A+" by Fitch Ratings. We also planned to enter the market with $400 million in traditional tax-exempt bonds at the same time. As you know, traditional tax-exempt municipal bonds and the taxable Build America Bonds are priced and structured differently.

Traditional tax-exempt bonds are structured with serial maturities, or with part of principal amount due each year, much like a mortgage. Often, there are also larger maturities, called term bonds, at the end of the amortization schedule, similar to a balloon payment on your mortgage. The serial and term bond structure allows the issuer to repay part of the principal and interest each year until the bond is repaid. Traditional tax-exempt bonds are generally priced relative to the Municipal Market Data yield curve which is an index of AAA-rated municipal bonds. The yield or coupon on tax-exempt bonds is lower than taxable bonds which take into account the benefit of the tax-exemption.

In contrast, tax credit bonds, including Build America Bonds generally need to be issued with long-dated, bullet maturities which are common in the corporate taxable bond market. In other words, the entire principal amount would be due in one lump sum payment. Build America Bonds, like other corporate/taxable bonds, are priced relative to 30-year U.S. Treasury bonds, which are measured as a spread to Treasuries, and have higher yields or coupons.

Because Build America Bonds are a new product type, MTA was optimistic that this structure would expand the pool of investors and increase market access.

The State of California, the New Jersey Turnpike, and the MTA all priced their Build America Bonds the same week, each on a different day. MTA watched the market response to these bond offerings very closely, noting that demand for both issues was strong. Not only were both California and the New Jersey Turnpike able to increase the amounts of bonds offered, but they were also able to decrease the spread to the 30-year Treasury – effectively lowering the cost of the borrowing. MTA initially planned to offer $200 million in Build America Bonds; however, after seeing the response by the market, we increased the initial amount of Build America Bonds to $500 million.

Mr. Chairman, as with the State of California and the New Jersey Turnpike Authority, the MTA experienced solid investor demand for both the tax-exempt bonds and Build American Bonds. As a result of the strong investor demand the borrowing was increased to $750 million from $200 million for the Build America Bonds. These bonds were priced at 3.50% plus the 30-year Treasury rate of 3.836% for a yield of 7.336%. After taking into the account the 35% federal subsidy, the cost of the bonds to the MTA was 4.768%. In comparison, our current budget assumption for this credit is 5.88%. The Build America Bonds financing resulted in a net present value savings of approximately $46 million as compared to a similarly structured tax-exempt issue. As a result of this new program, we were able to lock in very favorable rates for half of our necessary borrowing in 2009. This is very important because the ability to issue $750 million at such a favorable rate will take away from much of the uncertainty of the MTA's debt service budget while providing real savings especially during difficult budget times.

Another benefit of the Build America Bond program is the expansion of the investor base for municipal bonds. There were approximately 35 new investors in the MTA Dedicated Tax Fund that received sizable allocations. By attracting new investors, municipal issuers like MTA are able to expand and diversify the investor base which will help to achieve more efficient pricings in the future.

Build America Bonds are an important step forward for our market and benefits issuers, taxpayers, and new investors. Congress was also wise to include other bond provisions in the ARRA to help state and local governments, such as expanding the bank deductibility provisions, which provide incentives for banks to invest in municipal credits, and also excluding private activity bonds from the AMT. I am hopeful that Congress will look at all of the Bond provisions included in the ARRA, and make them permanent so that state and local governments can continue to benefit from these provisions after they are scheduled to expire next year.

There are also other ways that Congress can help the market and allow for more affordable tax-exempt financing to state and local governments. These include allowing for an additional advance refunding, streamlining complicated arbitrage rebate regulations, increasing the allowable private use percentage on public projects, and expanding direct grant programs for infrastructure investment. And as I mentioned previously, state and local issuers have a significant need for access to bank liquidity, which is in short supply, and if available, very costly.

Again, thank you for the opportunity to testify here today. I'm happy to address any questions you may have.

Chairman NEAL. Thank you, Mr. McCoy.
Mr. Decker.

STATEMENT OF MICHAEL DECKER, CO–CHIEF EXECUTIVE OFFICER, REGIONAL BOND DEALERS ASSOCIATION, ALEXANDRIA, VIRGINIA

Mr. DECKER. Thank you, Chairman Neal, Ranking Member Tiberi, and other Members of the Subcommittee. I appreciate the opportunity to be here today.

Like all other sectors of the capital markets, the municipal bond market has been acutely affected by the global financial crisis. Last fall, for a time at the height of the crisis, it became nearly impossible for most States and localities to access the capital markets to finance investment projects.

The market has recovered significantly since then, in part with the help of legislation advanced by the Ways and Means Committee. But now, State and local governments are dealing with the sometimes severe fiscal stress brought about by the recession and the downturn in real estate markets.

The American Recovery and Reinvestment Act includes a number of provisions that have helped States and localities weather the financial crisis. My written statement offers comments on all the municipal finance provisions included in the law. In the interest of time, I will focus my comments here on three provisions that have had the most positive effect: Build America Bonds, expansion of bank investment, and the tax-exempt bond market, and the AMT relief.

I am going to admit, Mr. Chairman, that when I first heard about Build America Bonds, I was skeptical that they would offer real benefits for States and localities. However, based on the experience of the last 2 months, I am now a believer. By allowing State and local governments to tap the taxable bond market without losing the generous interest subsidy associated with tax-preferred financing, Build America Bonds offer State and local governments a tool that often provides lower-cost financing than they could obtain through any other means.

Moreover, Build America Bonds have had the unanticipated effect of lowering borrowing costs in the tax-exempt bond market, as well. They are, in short, a huge hit.

That is not to say that Build America Bonds haven't raised some questions among market participants. They are challenging some of the standard structures that have been popular among municipal bond issuers for decades, like serial maturities and 10-year call provisions.

Also, there are doubts about whether Build America Bonds will be as effective for State and local governments when the interest subsidy rebate expires at the end of 2010, and the tax credit on the bonds accrues to investors, rather than issuers. While we don't think Build America Bonds can or should displace tax-exempt bonds as the dominant way for States and localities to finance capital investment, they're a great tool to help bond issuers weather the crisis.

Two other provisions of the stimulus legislation that have helped States and localities are expanding bank investment in tax-exempt bonds and exempting bond interest from the AMT. The bank investment provisions have helped restore the role of commercial banks as tax-exempt bond investors.

Before the 1986 Tax Reform Act, banks were dominant buyers of tax-exempt debt. The 1986 Act included tax law changes that effectively took banks out of the market for all but a small number of bonds. By bringing banks back, and thereby increasing demand for bonds, you have made it easier for States and localities to find investors for their debt at good terms.

Lifting the AMT on tax-exempt bond interest has helped reopen an important sector of the market that had been effectively closed since last year. It had become exceedingly difficult for issuers of private activity bonds for facilities like airports and economic development projects to obtain bond financing.

The spread, or difference in interest rates between AMT and non-AMT bonds, had increased to historical levels. The AMT holiday has addressed these issues, and made it possible for private activity bonds to be issued once again.

With respect to another set of provisions from the stimulus bill, authority for targeted tax credit bonds, such as clean renewable energy bonds and qualified energy conservation bonds, I think it is useful to point out to the Subcommittee that, in many cases, borrowers have had a hard time using this authority to raise financing. The Subcommittee may want to consider diverting all or a portion of the revenue cost associated with some tax credit bond authority to other more conventional types of financing, such as private activity tax-exempt bonds for energy facilities.

Also, I would like to bring to the Subcommittee's attention legislation that, even as we speak, is being discussed in the Financial Services Committee. Two bills under consideration there to help State and local bond issuers include provisions to exempt some new proposed programs from the section 149 Tax Code prohibition on Federal guarantees of tax-exempt bonds.

While these proposals—when these proposals come before the Ways and Means Committee, we urge you to approve them quickly.

The stimulus bill has certainly been successful in providing tools to State and local governments to continue to raise capital in a distressed market. We appreciate the work you all did in ensuring that State and local finance received meaningful attention in the stimulus legislation.

Thank you, again, for the opportunity to be here. I look forward to your questions.

[The prepared statement of Mr. Decker follows:]

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Statement of Michael Decker
Co-Chief Executive Officer
Regional Bond Dealers Association

before the

Subcommittee on Select Revenue Measures
Committee on Ways and Means
U.S. House of Representatives

Hearing on Tax-exempt and Taxable Governmental Bonds

May 21, 2009

Good morning, Chairman Neal, Ranking Member Tiberi and other members of the subcommittee. Thank you for the opportunity to be here and present the views of the Regional Bond Dealers Association (RBDA)[1] on tax-exempt and taxable governmental bonds and the municipal bond provisions enacted with the American Recovery and Reinvestment Act (ARRA).

Regional bond dealers play a vital role in the municipal market of underwriting new bond issues for states and localities and providing secondary market liquidity to investors. This role has expanded during the financial crisis with the consolidation, downfall or withdrawal from the market of a number of large municipal bond dealers. During the height of the crisis in the fall and winter of 2008, the only source of liquidity available to many investors were regional dealers. We believe the role of regional firms in the municipal market will continue to expand, and we appreciate the opportunity to present our views.

Tax-exempt municipal bonds are one of the most important sources of federal aid to states and localities. The tax-exemption on most municipal bonds means that states and localities can borrow in the capital markets at rates much lower than they otherwise would. The tax revenue that the federal government foregoes on tax-exempt bonds helps state and local governments invest in schools, roads, airports, water and sewer systems, hospitals, parks and a variety of other public assets. The Joint Committee on Taxation estimates that in fiscal year 2009 alone, the federal government will give up nearly $35 billion in tax revenue so that states and localities can

[1] The Regional Bond Dealers Association is the organization of securities firms primarily active in the U.S. bond markets and is the only U.S. organization focused exclusively on issues in the domestic fixed-income markets. More information on the Regional Bond Dealers Association is available at www.regionalbonddealers.com.

borrow more cheaply using tax-exempt bonds to finance vital public investment.[2] Tax-exempt bonds have been a mainstay of municipal finance since the inception of the income tax, and are an effective, efficient means of delivering federal assistance for state and local investment, and this aid is more important than ever in the current economic environment. We commend you, Chairman Neal, for calling this hearing to examine such a vital area of the tax code.

Today, as a result of congressional action earlier this year, state and local governments have at their disposal an even wider variety of federally supported tools to finance public investment. The ARRA (P.L. 111-5) included expanded authority for some existing alternative financing tools for states and localities and added new options for financing such as Build America Bonds that have already saved state and local government millions in capital costs.

Build America Bonds

The provision from the ARRA that has had the most significant short-term effect on state and local capital finance has been the Build America Bonds (BABs) program. BABs have allowed state and local governments to tap the taxable bond market while still maintaining a generous federal subsidy of their interest expense. Under the BAB authority provided in 2009 and 2010, state and local governments that issue designated taxable bonds for qualified projects receive a cash rebate from the federal government equal to 35 percent of their interest expense.

This subsidy has proven to be an attractive means of financing for state and local governments. Over $9 billion of BABs have been issued since the first transaction was sold in late March.[3] BAB transactions have ranged from a few million dollars of bonds for small communities to billions of dollars for large state issuers. Estimates of total BAB issuance over this year and next range as high as $150 billion.

BABs are popular because they often result in a lower cost of borrowing net of the federal interest subsidy than traditional tax-exempt bonds. Cost savings experienced by BAB issuers relative to tax-exempt bonds range from 35 to 185 basis points (0.35 to 1.85 percentage points). This reduction in borrowing rates will translate to billions of dollars of interest savings for states and localities over the life of their bonds.

BABs work well for many municipal bond issuers because they allow states and localities to continue to benefit from a federal subsidy while selling bonds to taxable investors who normally would not consider municipal bonds because they cannot take advantage of tax-exempt interest. These investors include pension funds, foreign investors, life insurance companies, retirement accounts, certain trust accounts and others whose investment income is not taxed in the U.S. or is tax-deferred.

BABs have also had the effect of lowering borrowing costs for issuers of traditional tax-exempt bonds. Because there is less new supply of tax-exempt bonds, investors have bid up prices of

[2] Staff of the Joint Committee on Taxation, *Estimates of Federal Tax Expenditures for Fiscal Years 2008-2012*, U.S. Government Printing Office, 2008.
[3] The Bond Buyer, "'Build America Bonds' Issues," May 15, 2009, www.bondbuyer.com/attachments/20090510A6SR01FZ-1-BABs_CHART.pdf.

longer-term bonds and reduced yields and interest rates for issuers. This effect may be responsible for lowering borrowing costs for issuers of long-term tax-exempt bonds by as much as 50 basis points (0.5 percentage point) or more.

So far only a handful of new issues have used BABs, but the experience of state and local governments using BABs has been positive. There are however concerns related to selling taxable municipal bonds.

The taxable bond market is accustom to bond structures and redemption provisions that are constraining for municipal bond issuers. In particular taxable investors show a preference for bullet maturities, which corporate issuers can more easily accommodate. Municipal bonds are frequently structured to pay down principal and interest over the term of the loan, not with a bullet maturity. Taxable investors typically also expect to have more restrictive early redemption provisions, which can be excessively costly to a municipal bond issuer. Municipal bonds are often sold with a 10-year early redemption option that comes at little or no cost.

It is also worth noting the following observations on the early performance of the BAB market:

- Several BABs that have been sold thus far have exhibited a trend where bond prices in the secondary market increase (and yields fall) significantly shortly after issuance, sometimes the same day the bonds are priced as new issues. While on the one hand this demonstrates the attractiveness of BABs among taxable bond investors, it also suggests inefficient pricing in the primary market. It is possible that at least part of this trend is attributable to the novelty of BABs and that the trend will wane over time, with issuers receiving even more favorable pricing at issuance.

- BABs arguably represent a costlier federal subsidy than traditional tax-exempt bonds. Although theoretically the 35 percent interest subsidy associated with BABs should be offset by tax receipts associated with taxable interest payments, many BABs are bought by investors who do not pay current U.S. income tax on their interest income, so there is a significant net cost to the Treasury of the program. We believe this cost is justified for the temporary period that BAB authority is in place to help states and localities access the capital markets cheaply during the crisis.

- There is some uncertainty about the viability of BABs after the expiration of the two-year interest subsidy provision. After 2010 BABs will be structured so that investors receive a federal income tax credit equal to 35 percent of the bond issuers interest cost. The option for issuers to receive the credit as a cash subsidy will expire. We see little market acceptance of tax credit bonds, and some market participants are concerned that BABs may not represent a viable financing option after 2010.

Overall we believe BABs offer an efficient and cost-effective financing tool for states and localities. Their popularity and growth over the last two months is a clear indication that they are delivering the kind of assistance to state and local governments that the committee intended when BABs were conceived. This is likely even more the case for Recovery Zone Economic Development Bonds (RZEDBs), also authorized in ARRA, since the interest rebate provision is even more generous than with BABs (45 percent for RZEDBs versus 35 percent for BABs). While we feel that tax-exempt bonds will continue to play a dominant role in state and local finance—if for no other reason than the interest rebate election under the BAB authority is due to expire at the end of 2010—BABs provide an attractive alternative.

Bank investment provisions

The ARRA includes three provisions designed to encourage greater investment by commercial banks in tax-exempt bonds issued in 2009 and 2010. First, the annual issuance limit for bank qualified tax-exempt bonds has been raised from $10 to $30 million. Second, the "two-percent *de minimis* rule" for non-bank corporate investors in municipal bonds has been extended to commercial banks. Third, the small-issuer bank qualified limit has been amended so that the bonds of a borrower falling under the $30 million annual limit are still bank qualified even if the issuer selling bonds on behalf of that borrower issues more than $30 million annually.

These provisions represent a positive and important change in policy to increase demand for tax-exempt bonds. Before 1986, commercial banks were active investors in the tax-exempt bond market. The Tax Reform Act of 1986 created significant disincentives for bank investors in tax-exempt bonds in the form of a *pro rata* interest expense disallowance for banks that earned tax-exempt interest from any bonds other than bank qualified bonds. As a result, banks went from holding over half of all outstanding tax-exempt bonds before 1986 to less than 10 percent in recent years.

The bank investment provisions of ARRA have had the effect of enhancing the market for small tax-exempt bond issuers who sell between $10 and $30 million of bonds annually. Although the spread between bank qualified and non-bank qualified bonds has shrunk significantly since the enactment of ARRA, it has become easier for issuers whose bonds are now bank qualified to place those bonds with investors.

With regard to the two-percent safe harbor provision for commercial banks, our members have noticed that some bank investment managers have been slow to expand their tax-exempt bond portfolios into non-bank qualified issues even where they are eligible to buy those issues without penalty under the safe harbor. We attribute this reticence to a lack of familiarity with the new law. Bank investment managers for many years have focused their attention on bonds that carry legal opinions designating them as bank qualified. We believe that over time banks will recognize that non-bank qualified bonds are now eligible for bank investment under the two-percent safe harbor and will begin to adjust their portfolios accordingly. In the meantime, we encourage members of the subcommittee to use available opportunities to promote the two-percent safe harbor among bank investment managers and tax directors so that the provision will have as deep an impact on state and local finance as Congress intended.

Alternative minimum tax

One of the sectors of the municipal bond market hardest hit by the credit crisis has been bonds the interest on which is subject to the individual alternative minimum tax (AMT). Beginning in the second half of 2008 it became exceedingly difficult to price and sell new AMT bond issues, and consequently many investment projects simply could not obtain financing. The ARRA has suspended the application of both the corporate and individual AMTs to all "new money" municipal bonds issued in 2009 and 2010 and to bonds issued to refund issues that were originally sold in 2004 or later.

Applying the AMT to private-activity bond interest is inefficient and penalizes bond issuers unfairly. Investors who are subject to the AMT simply avoid buying AMT bonds. Meanwhile, issuers pay higher financing costs on their bonds in compensation for the risk that a non-AMT investors, through poor planning or unforeseen circumstances, could end up paying tax on AMT bond interest. The federal government collects very little revenue from applying the AMT to municipal bond interest, but bond issuers pay higher financing costs than they should.

The AMT provision in ARRA has had the effect of reopening the market for bonds that otherwise would have been subject to the AMT. This has made it possible to sell bonds such as small-issue industrial development bonds and bonds for certain airport facilities and other projects that fall under the definition of "private activity."

One change the subcommittee may want to consider is the limitation on the AMT provision in ARRA related to refunding transactions. ARRA specifies that refunding bonds can qualify for the AMT holiday only if the original bond being refunded was sold after December 31, 2003. Unfortunately, because most municipal bonds are sold with 10-year "call protection" and private activity bonds cannot be advance refunded—or refunded before the original bond becomes callable—this limitation effectively prohibits almost all refundings of outstanding AMT bonds. The only exceptions are variable rate issues which are always callable and issues with unusual or extraordinary call provisions. In order to provide issuers with maximum benefit and flexibility under the AMT provision of ARRA, the subcommittee may want to consider expanding the limitation on refunding AMT bonds outside the AMT. In addition, the subcommittee may want to consider permanently lifting the application of the AMT on tax-exempt bonds. It is an inefficient and unnecessary provision of the tax code that raises little federal revenue but results in higher costs for AMT bond issuers.

Additional tax-exempt bond authority

The ARRA includes authority for two additional categories of tax-exempt bonds, Recovery Zone Facility Bonds (RZFBs) and Tribal Economic Development Bonds. While we are not aware of any transactions that have come to market under this authority—indeed, the market is still awaiting guidance from the Treasury Department on the allocations of Recovery Zone Facility Bond authority—we believe that authority offers issuers useful new tools to finance needed investment. RZFBs, in particular, are roughly patterned after successful tax-exempt bond authority that was authorized after the September 11, 2001 terrorist attacks (Liberty Zone Bonds) and after Hurricane Katrina (Gulf Opportunity Zone Bonds). Both programs were successful in helping to restore the local economies in devastated areas, and we believe that the RZFB provision will provide similar tools for areas particularly hard hit by the recession.

The ARRA also includes some enhancements to existing tax-exempt bond authority, including:

- Expanded definition of "manufacturing facility" for small-issue Industrial Development Bonds; and
- Expanding qualification for bonds for high-speed rail facilities.

The RBDA supports both these provisions. We believe this additional authority will give states and localities additional flexibility to promote economic development and expansion.

Tax credit bonds

The ARRA includes several of provisions to establish or expand authority to issue tax credit bonds for a variety of targeted uses. These include:

- Expanded authority for New Clean Renewable Energy Facility Bonds (CREBs)
- Expanded authority for Energy Conservation Bonds
- Extension of Qualified Zone Academy Bond authority (QZABs)
- New authority for Qualified School Construction Bonds

We appreciate Congress' focus and commitment in exploring new, alternative tools to promote the ability of states and localities to meet their investment obligations. However, the market's experience with existing tax credit bond programs has demonstrated that this product is in most cases not an efficient way to promote and assist new investment. Our members have worked with issuers to attempt to use the existing authority for QZABs and CREBs, and in our experience, it is exceedingly difficult to use these tools effectively. There is not a broad or deep market for marketable tax credits, and in the case of CREBs, for example, the limited number of transactions that have been done have been inefficiently priced. Also, there is little secondary market liquidity for these structures, which raises costs for borrowers even further.

We believe a better approach for providing assistance and incentives for targeted investments such as renewable energy and energy conservation would be to expand the authority to use traditional private activity tax exempt bonds for these uses. Although the subsidy associated with tax-exempt finance is not as deep as the theoretical subsidy for tax credit bonds, we believe that in the end, expanding private activity tax exempt bond authority would result in more projects being financed.

Conclusion

The ARRA included a number of important and beneficial provisions designed to help states and localities continue to efficiently access the capital markets in the midst of the credit crisis. BABs, provisions to expand bank investment, the suspension of the AMT and expanded use of private activity tax exempt financing for distressed areas all offer the prospect of reduced financing costs for state and local governments who are facing severe fiscal constraints due to the recession and weakened real estate market. We appreciate and commend the Ways and Means Committee's work in crafting these important provisions.

We fear that the expansion of various tax credit bond programs will not be as fruitful. Our experience with QZABs and CREBs suggests transactions using these tools are difficult to execute and are often priced inefficiently. While we appreciate the committee's work in offering these tools to states and localities, we feel that the resources dedicated to these programs might be better refocused to expanding tax exempt financing authority.

In addition, we want to call the subcommittee's attention to additional pending municipal bond legislation that includes provisions under Ways and Means Committee jurisdiction. At the same time that this hearing is taking place, the Committee on Financial Services is conducting a hearing on legislation drafted by Chairman Barney Frank and others to aid states and localities in the wake of the financial crisis. Two of those bills include provisions which would amend Internal Revenue Code section 149 in regard to proposed federal credit and liquidity enhancement programs for state and local governments. We urge members of this subcommittee to support Chairman Frank's legislation and we hope that the Ways and Means Committee will act favorably on the tax provisions in those bills when they come before you.

We again appreciate the opportunity to present our views and look forward to your questions.

Chairman NEAL. Thank you very much, Mr. Decker. The AMT holiday that you referenced was my amendment, and I was amazed at how quickly it appeared in advertising.

Mr. DECKER. Absolutely.

Chairman NEAL. Mr. Esposito.

STATEMENT OF JAMES P. ESPOSITO, MANAGING DIRECTOR, GOLDMAN, SACHS & CO., NEW YORK, NEW YORK

Mr. ESPOSITO. Chairman Neal, Ranking Member Tiberi, and Members of the Committee, my name is Jim Esposito, and I lead the municipal and corporate financing business at Goldman Sachs.

Given my leadership role across both the taxable and tax-exempt capital markets business, I have a broad perspective on the new programs enacted by Congress as a part of the American Recovery and Reinvestment Act.

Build America Bonds have had a positive impact in three specific areas. First, they have lowered borrowing costs for State and local governments. Second, they have provided issuers a needed source of capital to fund infrastructure projects. And, third, they are improving the functionality of the capital markets for issuers and investors, alike.

Historically, the $2.5 trillion municipal debt market had provided States and municipalities access to capital at affordable borrowing rates. The capital market deterioration during 2008 created an exceptionally challenging environment where only the highest-rated municipalities and corporations had access to the capital markets.

Certain institutional investors exited the market permanently, and others sat on the sidelines, simply willing to ride out the storm. It became clear that expanding the traditional tax-exempt buyer base was needed to restore stability and long-term viability to the municipal market.

The Build America program has provided municipal issuers access to a separate and distinct buyer base. Access to this new taxable investor base has helped municipal issuers lower their overall borrowing costs, and diversify their funding streams. Build America Bonds have not eliminated the need for a tax-exempt market, but rather have provided an alternative through 2010.

A positive effect to the BABs program to date is the visible resurgence of the traditional tax-exempt market. As taxable investors grow more comfortable analyzing municipal credits, we are starting to see signs of an increased amount of structuring flexibility and pricing power.

The other large taxable program recently created is the qualified school construction bonds, otherwise known as QSCBs. The size of this program, as well as the ability for large school districts to fund education capital needs on an interest-free basis, will be two key components that will drive the ultimate success of this program.

If I can turn your attention for a second to the monitors, I appended an exhibit to my testimony. And they say a picture is worth 1,000 words. And I think this exhibit is rather powerful, and really speaks to the success of the Build America Bond program.

And just a brief explanation as to what you see in this exhibit. If you follow along the horizontal axis, those navy blue bar charts are tax-exempt issuance volumes, dating back to September 2008 on a weekly basis. If you move all the way to the right of the horizontal axis, the lightish blue color is issuance volumes under the Build America Bond program. And, to date, we have seen 9.25 billion issued under the Build America program in the past month, alone.

Now, more importantly on this chart is the red line. The red line represents the cost of borrowings to States and local governments. That is a AAA-rated composite of municipal bond yields, as a percentage of overall Treasury yields. Historically, municipal yields have traded at about 80 to 90 percent of Treasury yields.

And, as you can see, if you go back to the time of the Lehman Brothers bankruptcy filing in September of 2008, issuance volumes from municipal clients started to really dry up. And, just as importantly, borrowing costs really spiked, reaching a peak at year-end 2008. And we saw municipal yields trading at almost two times the rate of underlying Treasury yields. So, market access really seized up, and borrowing costs spiked.

Now, as we get into the new calendar year, you can see borrowing costs starting to fall significantly. I think it's important to point out, as a part of the market anticipating the positive impact of the American Recovery and Reinvestment Act, yields started to fall. And they continued to fall during the period in which the Build America program actually got rolled out.

It is not just issuers who have financed debt under the Build America program who have benefitted. With borrowing costs falling in a taxable market, whether you use the program or not, all municipal clients have been beneficiaries of this program.

In conclusion, the taxable bond options recently enacted have had the immediate effect of lowering borrowing costs to State and local governments, while providing investors with a compelling opportunity to diversify their portfolio holdings. Congress, and this Committee specifically, should be commended for providing municipalities access to new liquidity sources during these challenging times. We encourage Congress to monitor the stimulus-related financing programs to determine if, at the end of 2010, any or all of these programs warrant extension or even expansion.

On behalf of Goldman Sachs, I appreciate the opportunity to appear before the Committee today, and I look forward to taking your questions.

[The prepared statement of Mr. Esposito follows:]

Testimony of James P. Esposito
Managing Director
Goldman, Sachs & Co.
Subcommittee on Select Revenue Measures
Committee on Ways and Means
U.S. House of Representatives

May 21, 2009

Chairman Neal, Ranking Member Tiberi, and Members of the Committee, my name is Jim Esposito and I lead the Municipal and Corporate Investment Grade new issue financing business at Goldman, Sachs & Co.

I appreciate the opportunity to appear before you today to provide Goldman Sachs' perspective on the municipal bond market, particularly new programs providing innovative taxable bond options to both issuers and investors. Given my leadership role across both the taxable and tax-exempt capital markets business, I have a broad perspective on the new programs enacted by Congress as part of the American Recovery and Reinvestment Act (ARRA) and signed into law by President Obama on February 17, 2009.

Mr. Chairman, as your invitation to testify requested, my testimony will focus on the reaction by both issuers and investors to two particular programs: the Build America Bonds (BAB) and the Qualified School Construction Bonds (QSCB). These programs have had a materially positive impact in the following areas: 1) lowering borrowing costs for state and local governments, 2) providing issuers a needed source of capital to fund infrastructure projects, and 3) improving the functionality of the capital markets for issuers and investors.

Goldman Sachs and Municipal Finance

Goldman Sachs has a long history of helping states and municipalities access the capital markets. Since Goldman Sachs entered the public finance business in 1951, we have been one of the largest industry participants. We serve our municipal clients in many capacities, including acting as advisor, market-maker, underwriter and co-investor to help them meet both their short and long-term financing goals. Over the past 10 years alone, we have helped states and municipalities raise over $250 billion of total capital.

Our business at Goldman Sachs is institutionally dominated, with the vast majority of our capital commitments made on behalf of corporations, institutional investors and governments. We do not engage in many traditional commercial banking activities and are not a significant lender to consumers. As a financial institution focused primarily on this "wholesale" client base, Goldman Sachs provides liquidity to institutions, which is a vital component of a functioning capital market.

Goldman Sachs is an active member of the Securities Industries Financial Markets Association (SIFMA) and serves as the chair of the SIFMA Municipal Securities Division. SIFMA's Municipal Securities Division has been vigorously supportive of proposals, like the taxable bond options that are the focus of this hearing and provide capital access and liquidity to municipal issuers.

The Municipal Market Before BABS

Historically, the $2.5 trillion municipal debt market had provided states and municipalities access to capital at affordable borrowing rates. The credit market deterioration of 2008 created an exceptionally challenging environment where only the highest-rated municipalities and corporations had access to the market. Certain institutional investors exited the market permanently and others sat on the sideline to wait out the storm. During this time, the auction rate market failed, the variable rate market experienced significantly higher interest rates and an overall lack of liquidity pervaded the market. It became clear that expanding the traditional buyer base for municipal securities was needed to restore stability and long-term viability to the municipal market. Although the beginning of 2009 saw an improvement in some of these areas, a broad portion of the market was still unable to issue debt. Throughout this period, tax exempt bonds traded at historically high yields relative to Treasuries. Under normal market conditions, yields on highly rated municipal bonds trade with a yield between 80-90 percent of respective Treasury yields. During the peak of the credit crisis, municipal yields moved as high as 209 percent - a clear sign of dislocation in the market. Attached to my testimony is a chart that illustrates this point.

Markets Are Validating BAB Taxable Bonds

The taxable Build America Bonds (BABs) provide eligible municipal issuers the ability to issue taxable bonds and receive a 35 percent direct payment from Treasury to pay a portion of the interest on the bonds. BABs are proving to be a major success with issuers and investors alike with $9.25 billion in issuance from 27 different municipal issuers since the ARRA was signed into law on February 17th. Major issuers from across the country have issued BABs in the last month, including the University of Virginia, the State of California, the New Jersey Turnpike Authority, the Metropolitan Transportation Authority of New York, the Illinois State Toll Highway Authority and even smaller issuers such as Sedgewick Kansas Unified School District, the City of Glendale, Wisconsin and the City of Council Bluffs, Iowa.

The passage of ARRA and enactment of the BABs program gave municipal issuers access to a new, robust buyer base in the taxable investment grade market. Investors that previously did not buy municipal debt because they could not take advantage of the tax exempt status, now could achieve comparable after tax returns. To give you a sense of the comparative scale, the taxable market currently has over $6 trillion in outstanding debt as compared to the $2.5 trillion tax-free municipal market. Access to this new taxable investor base has helped municipal issuers diversify their funding sources by tapping a new and deep pool of liquidity. Two key observations about recent BABs financings:

Supply Demand Balance Restored- BABs issuance has taken some of the supply pressure off of the traditional tax-exempt market. This has improved the supply and demand balance resulting in lower borrowing costs for municipal issuers as the benchmark for pricing tax-exempt bonds has reduced notably since ARRA was passed. Build America Bonds have not eliminated the need for a tax exempt market, but rather have provided an alternative through 2010. The traditional tax-exempt market will continue to be attractive for certain issuers. A positive effect to the $9.25 billion of BABs issued to date is the visible resurgence of the traditional tax-exempt market.

Structuring Flexibility and Price Discovery- The BABs alternative provides a compelling financing tool for states and municipalities to meet their borrowing needs. Creating the opportunity to access a separate and distinct buyer base, issuers can now select the lowest all-in cost of funding, comparing investor demand, and price views up until the bond pricing date. As taxable investors grow more comfortable analyzing municipal credits, we are seeing an increased amount of structuring flexibility and price tension. Recently, taxable investors have been willing to purchase callable and amortizing bond. Further, BABs pricing has become even more attractive for issuers, directly lowering the borrowing costs for states and municipalities.

Qualified School Construction Bonds

The other taxable program created by ARRA is the Qualified School Construction Bonds (QSCBs). Two factors will drive the ultimate success of QSCBs:

Size of the Program- With $22 billion of tax-credit financing authorized and allocated to states and large school districts to fund their capital needs for K-12 education through 2010, the program has attracted immediate attention of issuers and prospective investors alike. We believe a robust market will develop including a broad investor base. Goldman Sachs was privileged to complete the first QSCB transaction last month with the San Diego Unified School District. Although the issue was small in size, $38.8 million, we were able to identify and educate a buyer base that did not previously exist. We believe this initial QSCB offering will be the first of many as states and investors gain full understanding of this valuable tool to finance education.

Interest-Free Financing- With states and large school districts able to fund education capital needs on an interest-free basis, this program provides a valuable financing option.

The QSCBs and other tax-credit programs created and expanded under ARRA contain more attractive investment provisions for both issuers and investors than previous programs. However, with only one publicly traded issue sold to date, the ultimate benefits of this tool will only be transparent as markets evolve.

Further Aid to Municipal Issuers

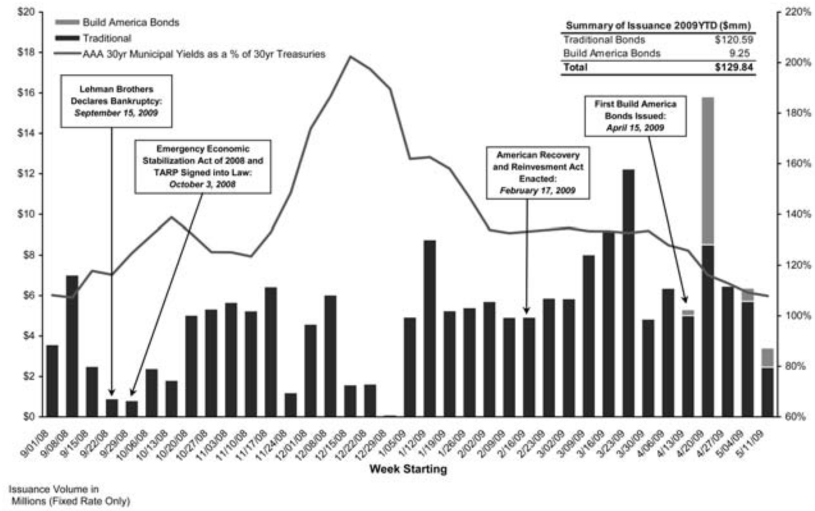
While BABs have succeeded in easing the strains for longer maturities, there are still short-term funding problems. There is a general liquidity issue, and states and cities are at risk of not being able to pay day-to-day obligations as their tax bases shrink, credit facilities expire and access to new capital may be limited. Additional legislation may be needed to address these issues. For example, legislation recently introduced by House Financial Services Committee Chairman Barney Frank aimed at providing short-term liquidity to municipal issuers could help address a number of key concerns.

Conclusion

The municipal taxable bond options enacted in ARRA have had the immediate effect of lowering borrowing costs to state and local governments while providing investors with a new opportunity to diversify their portfolio holdings. Congress and this Committee specifically should be commended for providing municipalities' access to new liquidity sources during challenging times. We encourage Congress to monitor the stimulus-related financing programs to determine if, at the end of 2010, any or all of the programs warrant extension or expansion. Goldman Sachs is committed to the municipal bond market. On behalf of Goldman Sachs, I appreciate the opportunity to appear before the Subcommittee today to share our views and look forward to any questions.

Historical Municipal Issuance and Long-Term Yields

Impact of Build America Bonds



Chairman NEAL. Thank you very much, Mr. Esposito.
Mr. Bornholdt.

STATEMENT OF GARY W. BORNHOLDT, COUNSEL, NIXON PEABODY LLP, WASHINGTON, D.C.

Mr. BORNHOLDT. Good morning, Mr. Chairman, Ranking Member Tiberi, and Members of the Subcommittee. Thank you for holding this important hearing today, and thank you for giving me the opportunity to testify.

While I was with joint counsel a little over a year ago, I had the opportunity to work on many of the tax-exempt and tax bond provisions that we are discussing here today. In my current position as a tax-exempt bond attorney with Nixon Peabody, I now have the opportunity to assist State and local governments in their efforts to utilize many of these new programs.

But the past year has certainly presented challenges in that regard. As we have heard from other witnesses today, the global credit crisis and the economic downturn has made it significantly difficult for State and local governments to access the capital markets. This, in turn, has had a significant impact on the ability of State and local governments to finance essential governmental services and facilities.

We are seeing some improvements for higher-rated municipal issuers. However, access to the bond market continues to be a problem for many State and local governments.

The American Recovery and Reinvestment Act provided State and local governments with a number of new financing tools and modifications to existing programs that have the potential to increase the demand for bonds and improve the overall efficiency of the markets. And, as we have heard from the other witnesses today, we are already seeing improvements due to some of the provisions that have been enacted.

Yet, not all of the bond provisions have been fully utilized as of yet. For example, the Recovery Act authorized a $25 billion bond program for economically distressed areas that cannot be used until initial guidance is issued by Treasury.

More generally, because many of the bond programs in the Recovery Act are so innovative, issuers would benefit from additional guidance clarifying that the existing regulatory framework that applies to tax-exempt bonds, and that has been in place for more than 20 years, would also apply to many of the new bonds that have been established under the Recovery Act. This would also help to remove some of the uncertainties, with respect to the new programs.

That said, I would like to note that Treasury and IRS chief counsel have been incredibly responsive to issues that have developed regarding implementation of these new programs. The ability of Treasury to respond to these questions on a prompt basis is obviously of critical importance, given the temporary nature of many of these programs, and I am confident that the open dialogue the Treasury and IRS have had with the industry can continue.

As we have heard, the tax exclusion that is provided under the Internal Revenue Code for State and local government bonds helps to lower borrowing costs. And traditionally, this has provided State and local governments with an efficient source of capital for their financing needs.

In contrast, recent tax credit bond programs, which date back to about 1997, have—tend to be illiquid, and a market has not—an efficient market has not yet developed for these programs. And I think this is for a number of points that I would just like to summarize briefly.

For one, most of the tax credit bonds under present law share a common feature, in that the credit rate is set by the Department of the Treasury, and it is generally intended to be set at a level that provides deeper subsidy than provided for tax-exempt bonds.

However, as Treasury has acknowledged, it has not always managed to set the credit rate at the intended subsidy level, which has required tax credit bonds to go out at a discount, which lessens the value of the intended subsidy.

In addition, there has been a lack of demand for tax credits in general. Currently, a liquid market for tax credits does not exist. In the current economic climate, there has not been a strong demand for tax credits among taxable investors.

In addition, rules that would allow investors to sell the underlying tax credits separately from the principal component of the bond, which should, in theory, improve the marketability of the tax credit bonds, have not yet been released by the Department of the Treasury.

In addition, all of the existing tax credit bonds have been temporary or limited in size. The Clean Renewable Energy Bond program, for example, was initially capped at 800 million, when enacted in 2005. This amount has been increased over the years, and is currently at 2.4 billion, after the Recovery Act. But this is still a relatively small program, when contrasted with the approximately 19 billion of tax-exempt debt that was issued for public power in 2007 alone.

In addition, some of the tax credit bond programs have expired over time. For example, the QZAB program, Qualified Zone Academy Bonds, has expired, only to be reauthorized on a retroactive basis. These issues have made it difficult for efficient markets to develop, with respect to the existing tax credit bond programs.

Recently, Congress has enacted standardized rules for many of these existing tax credit bonds, which should help to address some of these issues regarding efficiencies. But Treasury guidance will probably need to be issued with respect to many of the new rules before the market can get comfortable with respect to the standardized rules that would apply to all tax credit bonds.

With regard to the Recovery Act, we see some of the most significant changes to the tax rules relating to municipal bonds since the Tax Reform Act of 1986. The Recovery Act contains provisions that should help improve the demand for tax and financing, such as the temporary elimination of the application of the AMT to bonds issued in 2009 and 2010, and the relaxation of deductibility restrictions, also for bonds issued in 2009 and 2010. These demand-side incentives are already providing benefits to the market, and there are sound policy reasons for making these provisions permanent.

The biggest program, from the standpoint of State and local governments, is probably the Build America Bond program, which we have heard about here today. And, as we have heard, there are two types of Build America bonds: The tax credit bond version, which operates similar to existing tax credit structures; as well as the direct pay version.

I am not going to go through the technical details of the two types of the program. But as we have heard here today, we have seen significant interest in the direct pay version of the Build America bonds. And I think this is, in part, due to the fact that, in some cases, there may, in fact, be a deeper subsidy for the Build America Bonds direct pay than associated with tax-exempt bonds.

But I think it's also due to the fact that, for this new product, investors have not had to digest many of the new rules that would apply to tax credit bonds, generally. Rather, the market is purchasing a taxable bond, and it is the issuer that is receiving the direct benefit from the Federal Government in this case.

Finally, in conclusion, I would like to say that, due to the temporary nature of these programs, it may be difficult for robust markets to develop in the short period of time we have to issue bonds under the Recovery Act programs. So I think it is necessary to extend many of these programs in order for Congress to get a full sense of the value that they could provide, as a complement to tax-exempt bond financing, generally.

In addition, I would like to mention that today the results that we're hearing going on in the Financial Services Committee address some of the liquidity issues that still remain in the tax-exempt bond market, and some of these issues will also impact tax-exempt bond requirements. For example, there are issues relating to Federal guarantees, which are generally prohibited under the Internal Revenue Code. Some of the proposals that are being considered by the Financial Services Committee, for example, would require amending these Federal guarantee prohibitions, in order for these new liquidity proposals to operate efficiently.

Thank you for the opportunity to testify. I look forward to your questions.

[The prepared statement of Mr. Bornholdt follows:]

NIXON PEABODY LLP
ATTORNEYS AT LAW

Statement of Gary W. Bornholdt
Public Finance Counsel

Testimony before the Subcommittee on Select Revenue Measures of the House Committee on Ways and Means

May 21, 2009

Good morning Mr. Chairman, Ranking Member Tiberi and Members of the Subcommittee. Thank you for holding this important hearing and thank you for giving me the opportunity to testify. As a tax-exempt bond attorney with the law firm of Nixon Peabody, I represent State and local governments and other market participants with respect to the issuance of tax-exempt municipal bonds and tax-credit bonds. Over the past year, I have observed the significant difficulties State and local governments have faced accessing the capital markets due to the global credit crisis and the economic downturn. Late last year, for example, issuers of short-term municipal debt saw their borrowing costs jump from 2% to more than 10% in some cases. Some lower-rated government borrowers were simply shut out of the credit markets. This inability to access the bond market on an efficient basis adversely impacted the ability of State and local governments to finance essential government facilities and services.

While we are seeing some improvement for higher-rated municipal issuers, efficient access to the bond market continues to be a problem for many State and local governments. The American Recovery and Reinvestment Act of 2009 (the "ARRA") provided State and local governments with a number of new financing tools that have the potential to increase demand for municipal bonds and improve the overall efficiency of the markets. Yet, not all of the bond provisions in ARRA are being fully utilized. In part, this can be addressed through additional administrative guidance and legislation that conforms, to the extent possible, the various financing programs provided under ARRA with the existing statutory and regulatory framework for tax-exempt bonds.

The tax-exemption for State and local bonds

Under the Internal Revenue Code of 1986 (the "Code"), the interest income earned on debt issued by State and local governments generally is excluded from federal income taxation. This exclusion lowers the borrowing costs for State and local governments because purchasers are willing to accept a lower rate of interest on tax-exempt bonds than they could receive on taxable bonds. Thus, issuers of tax-exempt bonds receive a benefit equal to the difference between tax-exempt and taxable interest rates. The ability to issue tax-exempt bonds provides states, cities, counties, towns, school districts and other governmental entities with a valuable tool for financing infrastructure and other important facilities and services.

While not without considerable complexity, the tax-exempt bond provisions under the Code provide a well-developed set of rules and restrictions aimed at ensuring that tax-exempt bonds carry out public purposes. Operating within the existing framework of the Code, the tax-exempt bond market has grown to approximately $2.7 trillion in outstanding debt. In 2008, approximately $390 billion of bonds were issued. This is down from approximately $480 billion in 2007.

Tax-credit bonds

In recent years, Congress has provided State and local governments (as well as cooperative entities and tribal governments) with an innovative new financing tool, the tax-credit bond. Tax-credit bonds differ from tax-exempt bonds in that the economic equivalent of "interest" is paid through a tax credit against the bond holder's federal income tax liability. Most existing tax-credit bond programs have been designed to provide issuers with a deeper subsidy than tax-exempt bonds by shifting more of the interest costs to the federal government. For example, present law authorizes two types of tax-credit bonds for financing certain school costs, qualified zone academy bonds ("QZABs") and qualified school construction bonds. The Department of the Treasury is required to set the credit rate on these bonds in such a way that the issuer of the bonds pays no interest. Other types of tax-credit bonds, such as Clean Renewable Energy Bonds" ("CREBs") and Qualified Energy Conservation Bonds, require the Department of the

Treasury to set the credit rate in such a way that the Federal government pays approximately 70 percent of the interest costs on those bonds.

Although existing tax-credit bond programs have been designed to provide issuers with a deeper subsidy than tax-exempt bonds and can be a valuable tool for eligible issuers, acceptance of these programs has been slow and the market for these bonds generally has been illiquid. This is due to a number of factors, including:

- **Credit rate mechanism.** One of the common features of most tax credit bonds is that the Department of the Treasury sets the credit rate at the intended subsidy level. In contrast, for tax-exempt bonds, the market sets the applicable interest rate on the bonds. Treasury has acknowledged that it has not always achieved the objective of setting the credit rate on tax-credit bonds at the desired subsidy level.[1] As a result, tax-credit bonds have often sold at a discount or included supplemental interest coupons.

- **Demand for tax credits.** In order for a tax credit bond market to operate efficiently, there must be a liquid market both for the bonds and the tax credits, which does not exist at this time. First, in the current economic climate, investors have a diminished appetite for tax credits which results in a discounting of the value of the credit. In addition, rules that would allow investors to sell the underlying tax credits separately from the principal component of the bond, which should improve the marketability of tax-credit bonds, have not yet been issued by the Department of the Treasury.

- **Temporary and limited nature of the programs.** All of the existing tax-credit bond programs have been temporary or limited in size. The CREBs program, for example, was initially capped at $800 million when enacted in 2005. This amount has been increased and is currently at $2.4 billion after enactment of ARRA (of which $800 million is set aside for public power), but this is still a relatively small program when contrasted with

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1 Statement of Eric Solomon, Acting Deputy Assistant Secretary for Tax Policy, U.S. Department of the Treasury, *Testimony Before the Subcommittee on Select Revenue Measures of the House Committee on Ways and Means*, March 16, 2006.

the approximately $19 billion of tax-exempt debt that was issued for public power in 2007 alone. The authority to issue other types of tax-credit bonds also expired at various times during their existence, only to be later extended on a retroactive basis. The temporary nature and limited size of these programs has made it difficult to establish a market for tax-credit bonds generally. This issue can be addressed if Congress continues to expand and make improvements to these programs.

- **Separate operating rules.** Many of the tax-credit bond programs were established with different requirements and restrictions than those that generally apply to tax-exempt bonds. This also has affected the development of the tax-credit bond market to the extent these programs require implementing or interpretive guidance from the Department of the Treasury. In contrast, when new programs attempt to incorporate the existing regulatory framework that applies to tax-exempt bonds, there is less uncertainty which improves the initial utilization of the program. This can be seen in the rapid initial utilization of the Build America Bond program authorized by ARRA which generally incorporates the Code requirements for tax-exempt bonds. With the recent addition of standardized rules for tax-credit bonds, this may prove to be less of an issue as the Department of the Treasury provides additional guidance with respect to these standardized rules.

The ARRA

The ARRA contains the most significant changes to the tax rules relating to municipal bonds since the Tax Reform Act of 1986. The ARRA contains provisions that will help improve the demand for tax-exempt financing, such as the temporary elimination of the application of the alternative minimum tax for certain bonds issued in 2009 and 2010 and the relaxation of bank deductibility restrictions, also for certain bonds issued in 2009 and 2010. These demand-side incentives are already providing benefits and there are sound policy reasons for making these provisions permanent.

The ARRA also created new financing tools for economically distressed areas designated as "Recovery Zones." Based on past experience with special financing programs for the New York Liberty Zone and the Gulf Opportunity Zone, the Recovery Zone program may provide a valuable tool to assist economic recovery. However, this program has not been utilized yet as implementing guidance needs to be issued by the Department of the Treasury. In addition, issues exist regarding the size of the program as the total amount authorized is allocated to all the States, whereas prior programs were more targeted to affected areas.

Perhaps the most significant provision in the ARRA from the standpoint of issuers of State and local bonds is the new Build America Bond program. There are actually two types of Build America Bonds: Build America Bonds (Tax Credit), which are similar to existing tax credit bonds and pay investors both taxable interest and a federal tax credit, and Build America Bonds (Direct Payment), which provide state and local governments with a direct federal subsidy payment equal to 35 percent of the interest paid to investors on such bonds.

Build America Bonds (Direct Payment) can provide a deeper subsidy than tax-exempt bonds in some cases and we have seen significant interest in the program. Build America Bonds (Direct Payment) have already pushed sales of fixed-rate taxable debt in 2009 past the total for all of last year. The 2009 taxable bond sales by state and local governments to date is approximately $15 billion in 2009, surpassing the 2008 full-year total of $14.3 billion.[2] This, in turn, should provide benefits to tax-exempt issuers as the supply of tax-exempt bonds becomes more scarce.

The fact that Build America Bonds can provide a deeper subsidy than tax-exempt bonds does not fully explain the interest in the program. Existing tax-credit bond programs, for example, also provide a deeper subsidy, but a vigorous market for those bonds has not developed. Build America Bonds (Direct Payment) have been successful thus far because certain municipal issuers have been able to access the taxable investor market. Providing the federal subsidy through the direct payment mechanism also avoids the issues regarding the lack of a market for tax credits. In the case of Build America Bonds (Direct Payment), the market does not need to digest a new product because the bonds operate in the same manner as other taxable debt. In fact, the initial success of the Build America Bonds (Direct Payment) program also suggests that Congress should consider applying this direct payment approach to other types of tax-credit bond programs.

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2 Bloomberg, *Taxable Munis Top '08 Total Seven Months Early*, May 19, 2009.

In addition, part of the reason for the interest in and utilization of Build America Bonds (Direct Payment) can be attributed to the fact that the program generally incorporates the existing rules applicable to tax-exempt bonds. New tax-preferred bond programs work most effectively when provided for within the existing general framework of the tax-exempt bond rules.

The Build America Bonds (Direct Payment) program, however, is not without issues. The program represents a significant change in the way the Federal government delivers a subsidy to State and local governments in connection with the issuance of debt. In providing payments directly to State and local issuers, the program also changes the way the IRS interacts with municipal issuers. The IRS already has announced it is forming a special group that will review Build America Bond issuances and claims for the direct payments. In order for State and local interest in this program to continue, there will need to be clarification regarding the procedural protections afforded issuers in cases where the IRS challenges a claim for the direct payment on a Build America Bond. We continue to hear concerns from issuers regarding the possibility the IRS may discontinue the direct payments without issuers having clear recourse.

In addition, there are requirements imposed on Build America Bonds (Direct Payment), such as capital expenditure requirements, that generally do not apply to tax-exempt bonds. Since Build America Bonds generally follow the existing tax-exempt bond rules, there is a good argument that the existing rules also should apply when interpreting new Build America Bond requirements. However, because Build America Bonds are taxable bonds, it is unclear how a number of the existing rules apply to such bonds. Clarification from Treasury that the existing regulations applicable to tax-exempt bonds generally apply to Build America Bonds will remove additional barriers to the program.

Build America Bond also could be made more efficient by allowing Build America Bonds (Direct Payment) to be issued for any purpose a tax-exempt governmental bond may be issued, including refundings and working capital. To date, there has been little interest in Build America Bonds (Tax Credit), even though they can be used for these purposes.

The development of a robust market for alternative financing tools such as Build America Bonds will be hampered by the temporary nature of the program. Extending the program beyond 2010 will allow a market to develop. Only then will we be in a position to evaluate the overall benefits of the program and determine whether it is an effective complement to tax-exempt bonds.

Finally, as mentioned earlier, the municipal market continues to be affected by the credit crisis, particularly due to the impact on municipal bond insurers and the banks that traditionally provided liquidity support for the municipal market. While proposals to address these issues are largely being considered by other committees, the Committee on Ways and Means should be sensitive to these issues and the potential need to amend the Code in order to implement these proposals. For example, rules relating to the federal guarantee of tax-exempt bonds may need to be amended in order to implement proposals that would provide federal credit support for the municipal market.

Thank you, again, for the opportunity to testify and I look forward to your questions.

Chairman NEAL. Thank you, Mr. Bornholdt.

Secretary Krueger, I am interested in the guidance you have referenced for the recovery zone bond program. We have heard from some witnesses that we should consider extending the time for these programs. Do you expect this initial guidance will be comprehensive, especially for those jurisdictions which may be receiving a direct allocation, such as Springfield?

Mr. KRUEGER. Our goal is to produce the guidance as quickly as we can, which I think will be in a matter of a small number of weeks, and to make the program as administratively easy as possible for Springfield and other communities.

Chairman NEAL. Thank you. And, Mr. Culver, let me follow up on the line of questioning with you. I understand MassDevelopment has issued bonds on behalf of smaller jurisdictions in Massachusetts. As you know, the recovery zone bond program will not only have allocations for States, but for large cities and counties with severe job losses.

Do you expect MassDevelopment to assist with the recovery zone bond offerings? And, if so, what preparations have you made for the pending Treasury guidance that could come in a small number of weeks?

Mr. CULVER. Right. We are—as you know, we work with all 351 of the cities and towns in the Commonwealth of Massachusetts, as well as smaller banks. And we are really, right now, working with them to make them aware of the new programs, how they might use them, and how we can assist them, in fact, in making filings to take advantage of them, and also expressing to them their need to get their projects ready to go, if, in fact, they're going to use this type of debt financing.

Chairman NEAL. Right. And, Mr. McCoy, we have heard from other witnesses that the Build America Bonds may have been priced inefficiently, perhaps due to the fact that they were a new product on the market. As someone who has issued the Build America Bonds, what is your experience, in terms of pricing your bonds?

Mr. MCCOY. We went into the pricing of our bonds, again, both taxable and tax-exempt, on the same day, and evaluated significant amounts of information, market data from our financial advisor, as well as from our underwriters. And we felt that, given the fact that we were improving pricing relative to tax-exempt bonds, the Build America Bonds were—delivered the kind of savings we needed and wanted.

We have certainly heard those criticisms about particularly secondary market trading, and how that has improved the pricing, relative to the primary issuance. I think, given our experience, we were satisfied with the outcome, and would evaluate the issuance of BABs again in the future, with the same process and the same methodology that we used the first time.

Chairman NEAL. And, Mr. Decker, your testimony highlights support for the safe harbor provision, allowing banks to invest in tax-exempt bonds. You stated that many banks have not followed through. And, as you know, I pushed hard for this provision in the stimulus bill.

It is disappointing to hear what you have suggested. And can you explain to me why more banks have not increased their holdings?

Mr. DECKER. I think part of it is inertia. I think bank—many bank investment officers are used to buying bonds that have an explicit opinion, tax opinion, associated with the bonds, that they're bank-qualified.

And in expanding the eligibility for bank investment to non-bank-qualified bonds—to any bonds that are available in the market, I think it's just going to take a little time for bank investment officers and tax directors to get used to the idea that they can buy non-bank-qualified bonds and still not take a tax hit. Forums like this I think are good for publicizing that.

Chairman NEAL. This is very informative, just listening to your testimony, all of you, this morning. Very, very helpful.

Mr. Esposito, I was interested in the chart you presented. It shows a peak at the end of 2008 for municipal yields, as a percentage of the 30-year Treasuries. You refer to this as a dislocation.

And, first, have you seen this sort of dislocation before? And what amount of municipal borrowing usually occurs in the last quarter of the year? And what happened at the end of 2008?

Mr. ESPOSITO. Yes, let me start by saying that the dislocation that we saw in the capital markets was not specific to the tax-exempt market. There was a dislocation, globally, across all asset classes, other parts of the debt markets, the equity markets. So, this was a dislocation and a severe lack of liquidity. Liquidity left the system through a very violent de-leveraging process.

While, over the years, volume certainly slipped into year-end, the end of 2008, for the municipal market, were some of the thinnest volumes we have seen in the past decade. In terms of the success of the Build America program, and what that meant for issuance volumes and lowering the cost of borrowing for municipal clients, I think the graph is very telling. And, bear in mind, the markets were anticipating the passage of the Act.

So, while the lines started to fall at the beginning of the year, at that point in time market participants were already expecting the passage of the Build America program. So I think, in a lot of ways, the program should get credit for the decrease in yields, starting at the beginning of the year.

Chairman NEAL. Okay, thank you. Mr. Bornholdt, you suggest that Congress should look to extend the Build America Bond's direct payment model to other types of tax credit programs. Others have suggested that private activity bonds might be expanded to include these tax credit programs.

Mr. Houghton, a former Member of this Committee, we worked hard on that very issue, and we were very successful. What approach do you think would be better?

Mr. BORNHOLDT. Regarding either expanding the direct pay——

Chairman NEAL. Yes.

Mr. BORNHOLDT [continuing]. Version, or expanding the Build America Bonds to private activity bonds?

Chairman NEAL. Yes.

Mr. BORNHOLDT. Well, that is a good question. I mean, I think Congress has identified certain priorities in authorizing the Clean

Renewable Energy Bond programs and the School Construction Bond programs, by providing these particular programs with a deeper subsidy than provided generally through tax-exempt bonds, or even provided through the direct pay for Build America Bond programs.

For example, with the clean renewable energy bonds, Congress provides a subsidy that is approximately equivalent to 70 percent of the interest costs.

So, to the extent Congress continues to view renewable energy as a priority, school construction as a priority, and worthy of deeper subsidies than some other types of programs, the direct pay, which would provide a direct pay equivalent to the intended subsidy under the tax credit rate, would probably be preferable, in terms of delivering that deeper subsidy.

In terms of long-term—with respect to just general purpose activities, for example, we have seen programs similar to the Recovery Act facility bonds, which are essentially a type of private activity bond for any type of business purpose—that is, any depreciable property. We have seen those programs successful in other recovery areas, such as the New York Liberty Zone and the Gulf Opportunity Zone.

So, for more general programs, the private activity bond program which allows issuers to issue tax-exempt bonds for basically any purpose that the State or local government determines is a worthy financing opportunity, the private activity bond program may provide a better general purpose program. But with respect to those programs that Congress has specifically identified as worthy of a deeper subsidy, the direct pay is probably the more direct approach.

Chairman NEAL. Thank you. Mr. Tiberi is recognized to inquire.

Mr. TIBERI. Thank you, Mr. Chairman. Starting with Mr. Krueger, over the last 20 years we have seen an expansion on the use of tax-preferred bond financing through incentives in the amount of private activity bonds that the States can issue, and the addition of activities, as well, that qualify for tax-preferred bond financing.

In your view, what impact has that had for State and local governments in financing what we would all look at as traditional functions, like building bridges and roads, if any?

Mr. KRUEGER. I'm sorry, I'm not sure I understand the question. The question is how has the balance with private activity——

Mr. TIBERI. Yes. How has the expansion of activities and the use of these bonds for State and local governments impacted the building of roads and bridges by the whole government?

Mr. KRUEGER. I—this is not an area that I have studied directly.

Mr. TIBERI. We can go to other panelists and come back to you. Mr. Culver.

Mr. KRUEGER. But I would just emphasize that the private activity bonds are subject to the volume cap, which is going to, you know, often be a constraint on the amount of private activity that—private activity bonds that are issued, and that take place.

Mr. TIBERI. Thank you. Mr. Culver, any thoughts?

Mr. CULVER. I agree. I mean, the—they are a good addition to the debt that is already—needs to be incurred for these. If you look at our issue of the big dig and other issues that we deal with, they will not affect us in that financing, per se, if you will. I mean, we are still subject to a lot of other financing mechanisms.

But the—what is happening right now, in terms of the new issuance that you are considering, is really going to help us, in terms of what I deal with, small businesses, and assisting cities and towns, by giving them access to tax-exempt debt that they have not heretofore had. It will take some time, as has been noted, for the markets to get used to this. And it will also take time for these businesses and the smaller cities and towns to believe that they have the cashflow to pay the debt service, even though it is becoming more efficient and the cost of issuance is becoming less for them.

And that is why we're basically asking please extend this. Give us a little bit more time with this, because this—these new products will be more effective in the areas that we deal with, as the economy begins to pick up, and the markets begin to understand how to use these.

Mr. TIBERI. Mr. McCoy.

Mr. MCCOY. You know, I think our experience with the Build America Bonds issuance that we had last month was very successful. We improved our cost of financing, relative to tax-exempt financing, on a present-value basis. We saved approximately $46 million using the Build America Bonds, relative to doing that in a tax-exempt market.

At the end of the day, we used both tax-exempt and taxable, because we want to have flexibility, we want to be able to enter the market in ways that continue to tap into these different investor pools. I think, to the extent that we will come back to the market later in the year, and certainly next year—again, with heavy issuance—we're going to continue to look at this program as a tool that we would absolutely look to use.

Chairman NEAL. Mr. Decker.

Mr. DECKER. There are some uses for private activity bonds that are traditional infrastructure-type projects, not roads and bridges, but projects like water and sewer systems or airports, that are eligible for private activity bond financing. And I think that that—those provisions in the Code allow State and local governments to use public-private partnership arrangements, which are sometimes very efficient ways of financing traditional infrastructure projects when you have an element of private participation.

So, in that regard, I think the private activity bond authority has been helpful, in some cases, in helping get those kinds of projects financed.

Mr. TIBERI. Mr. Esposito.

Mr. ESPOSITO. I have nothing additional to add.

Mr. TIBERI. Okay. Mr. Bornholdt.

Mr. BORNHOLDT. Just with respect to private activity bonds, generally, I would note that, again, in the cases of the New York Liberty Zone and the Gulf Opportunity Zone, we saw a pretty rapid utilization of the additional 30 that was provided in those particular cases. And I think it was more than just because of the economic distress those areas were under. It was also because Congress provided fairly open-ended definitions of the type of property that could be financed.

For example, State and local governments could decide what type of private property could be financed. We see this again in the Recovery Act with the recovery zone bonds. It is basically any depreciable property. I think that has certain elements of efficiency that are more advantageous than the current structure of many of the private activity bonds.

For one example, solid waste facilities, which are a defined type of private activity bond, the IRS and the industry have spent years and countless dollars arguing over what is the definition of a solid waste facility. And this is a definition that was established under regulations dating back to the early 1970s. And obviously, as times have changed, we have different needs with respect to solid waste and recycling facilities, generally, but the Code and the regulations have not kept up.

To the extent Congress provides more of these open-ended definitions of economic purposes that can be financed in State and local governments, I think that has real advantages.

Mr. TIBERI. Thank you. I yield back.

Chairman NEAL. Thank you, Mr. Tiberi. Mr. Thompson is recognized to inquire.

Mr. THOMPSON. Thank you, Mr. Chairman. Thanks to all the witnesses for being here. I would like to carry on the discussion about the private activity bonds, and based upon what we did in the Recovery Act, and the success that the expansion of the private activity bonds have had in regard to renewable green projects.

I am pursuing legislation that would even expand that—I plan to drop the bill here as soon as we get back from the break—that would allow the use of the private activity bonds to fund, to a greater extent, renewable energy-type of projects.

In my home State of California, our treasurer came to me and said, you know, “I can use these to fund traditional energy facilities.” But at a time when we are trying to decrease the amount of money we are paying for foreign oil and to move toward more renewable energy, he believes it would be advantageous to extend that ability over to the green technologies.

And I would like to hear what you think about that in regard to two issues: One, what would it mean, from an economic stimulus perspective; and, two, any comments you might have on how this will help expedite our move to a renewable energy society. And we can start wherever you would like.

Mr. ESPOSITO. Well, why don’t I start by trying to frame some guiding principles, as you think about any changes or tweaks you make to existing programs, as well as think about what has been successful with what’s been rolled out to date.

I think we can glean some very important learning lessons from the Build America program. We at Goldman Sachs are also confident that the qualified school construction program will ultimately prove successful.

So, what is it about these two programs that are going to lead to success and a lot of investor receptivity in the capital markets? I think the first guiding principle that you need to bear in mind, that the size of the program matters. And I'm not just talking about the overall size of eligible debt that can be issued under it, but I am talking about the actual issuance amounts by any one entity.

What we have seen to date is that investors are willing to embrace programs that either have a lot of eligible size behind it, or at least individual issuance that will be of reasonable size that will merit their time, energy, and intention. So this is a place where size does matter.

Mr. THOMPSON. And doesn't size differ between projects?

Mr. ESPOSITO. It does, and that will be one of the issues that Congress will have to grapple with. And maybe there are other thoughtful ways that, together, we can think about efficiency gains by thinking about ways to roll up various issuance strategies into more liquid debt issuances.

Because, clearly, the marketplace is demonstrating a propensity to want to invest in more liquid alternatives. So that is point one. Second——

Mr. THOMPSON. Before——

Mr. ESPOSITO. Sorry.

Mr. THOMPSON [continuing]. You drill down too deep on the specifics, maybe I could get a commitment from you to work with my office to try and define some of these specifics that would make this bill an even better tool for what it is we want to do. And, because we're limited in time, maybe just hear, generally, what people think about the idea of whether or not the expansion will create economic activities and get us to where we need to go quicker.

Mr. ESPOSITO. We would be delighted to follow up with your office.

Mr. THOMPSON. Thank you.

Mr. DECKER. I think that would be a very welcome piece of legislation, Congressman. Members of ours tell me that—bond dealers that work with State and local governments tell me that they have projects that are ready to go that are related to energy generation or energy conservation, retrofitting buildings for energy conservation, or alternative energy-generating projects that are ready to go that don't make sense if the borrowing is taking place at 6 or 7 or 8 percent, but do if the borrowing is taking place at 2 or 3 or 4 percent.

And so, I think your idea would result in some very quick and meaningful investment activity.

Mr. KRUEGER. I would highlight that the Administration has made renewable energy a priority. And the President, you know, has strongly supported cap and trade policy. And the budget would use much of that revenue—I think it was $15 billion a year—for renewable energy research and development and implementation projects. So, we very much agree with the goal of trying to expand renewable energy.

As far as private activity bonds, I think a very important issue has to do with the revenue costs, which would have to be considered, how it relates to the current volume caps, and so on, which are issues that we would very much like to look at and work with after you do develop the bill.

The last question you raised about the economic recovery, I think, as an economist, I would say that it depends upon the speed in which the programs are put in place. And——

Mr. THOMPSON. Now, with the support of you and Goldman's, I think we can move it out pretty quick.

[Laughter.]

Mr. KRUEGER. Yes.

Mr. THOMPSON. Thank you.

Mr. CULVER. If I may, in the spirit of the size does matter, especially when you are on the little side of size matters—and for those of us who come from the New England States, there are many smaller entities that will be seeking to issue under this. And they may have a different experience in the markets than the larger issuers would. And I hope that they would not be discriminated against, because of their size.

Mr. BORNHOLDT. And I would just like to briefly add that Congress has recently authorized two tax credit bond programs for renewable energy: the Clean and Renewable Energy Bond program, which is a $2.4 billion program, as well as the recently enacted Energy Conservation Bond program, which is a $3.2 billion program.

And, to the extent that Congress is considering providing additional financing for these types of projects, I would urge Congress to continue to look at the existing programs, and ways to enhance those tax credit bond programs. For example, given the success with the Build America Bond programs, and the lack of a liquid market for tax credit bonds, generally, additional refinements to both the CREBs, as well as the Clean Energy Conservation Bond program might be warranted.

In addition, to echo the point regarding size, as I said, you know, there is $2.4 billion of clean renewable energy bonds authorized for the entire program, but public power, you know, in 1 year, issues approximately $19 billion. And that $2.4 billion for clean renewable energy bonds is actually divided into three parts for both State and local governments, which has been used primarily, for example, to put solar panels on top of courthouses, one-third for cooperative entities, and one-third for public powers.

All of those are, obviously, worthy goals. But, by splitting that $2.4 billion among the three different classes of issuers, it has obviously diluted some of the benefits of the program.

Chairman NEAL. Mr. Linder, the gentleman from Georgia, is recognized to inquire.

Mr. LINDER. Thank you, Mr. Chairman. Mr. Bornholdt, California's bond rating has recently been reduced to the lowest in the country of any State, from A+ to A. What kind of difference does that make in their interest payments, the cost——

Mr. BORNHOLDT. Well, as I said—and I think most of the witnesses said this morning—we are seeing some improvements in the markets, but that has generally been at the higher end of the ratings scale, for example, at the AA level.

When we get into the A level and the BBB level, and even lower, we are still seeing some difficulties accessing the market, which has impacted across. But I probably have other witnesses here who are more qualified to testify today regarding the pricing, with respect to California's——

Mr. LINDER. Mr. Esposito.

Mr. ESPOSITO. Sure. I would just point out that investors rely upon a lot of different factors and judgments to make a decision whether to purchase a bond or not. And, while clearly ratings are one of the important variables that go into that decision, investors do a lot of their own credit work.

And many of the investors had already factored into their analysis the credit conditions prior to the actual——

Mr. LINDER. Maybe somebody could try and answer the question. Would anybody like to take a shot at this? What difference would it make, in the savings or cost to a State, if their bond rating went from AA to A?

Mr. MCCOY. At the MTA, we have been looking at this issue, as our existing credits—we have had stability over the past few years.

But, as we look forward and look at stress in our own system, we have looked at the scenarios that we would confront. And a simple 1-notch downgrade for the MTA could cost us approximately 25 basis points. A 2-notch downgrade could—we estimate—could cost us approximately 75 basis points. And these are estimates, but obviously we are very sensitive to that, and work very closely with the rating agencies to maintain those ratings.

But given all the economic pressure that our revenue streams are under, you know, it is one of those scenarios that we have to be aware of and sensitive to.

Mr. LINDER. What would happen if the Federal Government decided—and this is just a matter of discussion right now; the Fed says no—but if our government decided to back-stop or guarantee California's bonds, would it raise the rating? Would it just lower the interest rate? What would happen?

Mr. Bornholdt, do you want to take a shot at that?

Mr. BORNHOLDT. Well, it wouldn't raise California's rating, per se, but it would certainly raise the rating on the underlying debt that the issuer—because, obviously, investors in that case are looking through to the ultimate guarantor on the bonds, which would be the Federal Government.

Mr. LINDER. So it would save California money?

Mr. BORNHOLDT. It would save money.

Mr. LINDER. The equivalent of 75 basis points?

Mr. BORNHOLDT. I don't know that I can testify regarding the pricing element——

Mr. LINDER. Mr. Decker, do you want to——

Mr. DECKER. I would say, based on where California is now, versus where they would issue if they got a full faith in credit Federal guarantee on their debt, it would be significantly more than 75 basis points.

The credit spreads in the market now, the difference in borrowing costs between different rating categories, are some of the widest that I have ever seen, as a result of the credit crisis, and de-leveraging, and illiquidity in the market. So there are big differences between rating categories now, much bigger than there had been for a long time.

Mr. ESPOSITO. You can also look to the FDIC, TLGP program as a proxy for what happened when the government started to guarantee individual commercial bank's debt. The savings to the banking system was more than 200 basis points in that example. And I think that's a pretty good place to borrow for what the impact would be on the State of California, as a place to look at for a judgment.

Mr. LINDER. Thank you. Mr. Esposito, I just can't—this is not on the subject of our hearing, but I can't resist asking you, from Goldman Sachs.

When the face value of credit default swaps exceeded the total economic output of all of this planet's nations, why didn't somebody say, "What the hell is going on?"

Mr. ESPOSITO. One thing I would point out is when you read about the amount of credit default swaps outstanding, bear in mind those are notional amounts. Many investors, many commercial banks, many Wall Street marketmakers, have offsetting positions. So, while that headline number is obviously enormous——

Mr. LINDER. $62 trillion.

Mr. ESPOSITO. Absolutely. If we were to net out the actual economic counterparty exposures, it would be significantly less than the number you just referenced.

Mr. LINDER. How is that hedging working so far?

Mr. ESPOSITO. I think it depends on each instance. There have been places where credit default swaps have been an effective hedging tool. And, clearly, there have been other places where it has worked far less well.

Mr. LINDER. Thank you, Mr. Chairman.

Chairman NEAL. Thank you very much, Mr. Linder. The gentleman from Connecticut, Mr. Larson, is recognized to inquire.

Mr. LARSON. Thank you, Mr. Chairman, and thank you for holding this hearing. I thank the witnesses for their testimony.

My question is for Mr. Krueger. Both Mr. Culver and Mr. Bornholdt stated in their testimony that the direct payment approach employed by the—that class of Build America Bonds has resulted in strong demand, and both favor extending the direct pay option to other tax credit bonds.

Could you please discuss Treasury's thinking on this matter?

Mr. KRUEGER. Well, the program, as I say in my testimony, is only in place for about a month. And while we're very pleased by the initial response, it is premature to say how successful the program will ultimately be.

The characteristics of the municipal bond market, tax-exempt market, tend to be different from the corporate taxable bond market. So, going forward, we need to study the reception of the bonds to reach a more informed judgment about the program after it's set to expire. What——

Mr. LARSON. What would you guesstimate that to be, in terms of time?

Mr. KRUEGER. How much time do we need?

Mr. LARSON. Yes.

Mr. KRUEGER. You know, I don't think I could put a figure on that. I think, as I said, the initial reports that we're getting, and as you heard on this panel, have all been very enthusiastic, and it seems to be very successful. But the financial markets are going through a serious evolution right now. And it's just very difficult to give you a precise timetable.

One thing I would point out, which is also, I think, worth paying attention to, is that the way that the Treasury has been computing the credit for tax credit bonds has changed. In January 2009, IRS implemented a new approach, which changed the tax credit bonds from being linked to AA corporate bonds to a blend of A, BBB ratings, in order to adjust the rates so that the bonds sell at par, as opposed to a discount. So, hopefully going forward, one of the issues which Mr. Bornholdt raised would be a less serious concern.

Mr. LARSON. Now, are you referring to Mr. Bornholdt's notion that with—the demand in liquidity in this market could be increased if Treasury were to rule that underlying tax credits may be sold separately from a principal component of the bonds?

Mr. KRUEGER. Well, my comment was just on how the tax credits were established, and how the rates were——

Mr. LARSON. Well, would you agree with that? Would that work?

Mr. KRUEGER. I agree that allowing investors to strip the credits would broaden the market for the bonds.

Mr. LARSON. So, what can we determine will Treasury have for rulemaking with respect to that, with this notion? And——

Mr. KRUEGER. Treasury has been working, together with IRS, to develop accounting rules and tax compliance rules to permit the stripping of the credits. And that is something that is a priority within the Department.

Mr. LARSON. How long a timeframe on that, do you think?

Mr. KRUEGER. I would—you know, if I were forced to give you—as an economist, I try not to answer questions about timeframe. But if I were forced to, I would probably say within the next few months.

Mr. LARSON. Well, as legislators, you can understand why——

Mr. KRUEGER. Yes.

Mr. LARSON [continuing]. With the economy being where it is, we are interested in time. And that is why it is always distressing when everything seems open-ended, and we go back to our districts and people are looking for—just a—thank you—a followup with Mr. Esposito on Mr. Linder's question, as well.

With regard to credit default swaps and derivatives, et cetera, the 60 Minutes piece that was out there, et cetera, some have noted with great interest that maybe those numbers are true and maybe they're not. How do we ascertain those numbers?

And would taxing those things be of interest, in terms of revenue, or a way of limiting the positions that are taken?

Mr. ESPOSITO. Well, we at Goldman Sachs are supportive of some of the initiatives to establish a clearinghouse by which credit default swaps will be settled, and it will be a very simple mechanism by which we can reduce the counterparty exposure between those that are engaging in trading of CDS, and legitimate hedging activities.

In regards to your point about taxing the trading of CDS, clearly any form of taxation will limit and reduce the activity. And I think it would just be a decision by Congress as to whether or not that is in the best interest of the marketplace. There are plenty of counterparties that require legitimate use of CDS for hedging and other purposes. And any form of a taxation will clearly limit the trading activity of those securities.

Mr. LARSON. How do you distinguish between those that are regulated, and those that have no regulation?

And is this—what would you put on a number? If it's not the 40 to 60 trillion that Mr. Linder talked, where do you think the ballpark is? You said it wasn't there, but where do you think it is?

Mr. ESPOSITO. I think it is significantly less, but it is just not my——

Mr. LARSON. It is significantly less than 30 to 40 trillion. Is it 20 trillion?

Mr. ESPOSITO. It is just not my area of expertise at Goldman Sachs, so it is difficult for me to give you an estimate on that.

Mr. LARSON. Who could give me an estimate on that?

Mr. ESPOSITO. I will work with my colleagues back in New York, and see if we can't come up with a netting number, which is, I think, what you're after, not the notional amount of CDS outstanding, but what we think the real exposure is, and see if we can't come up with that——

Mr. LARSON. Thank you, Mr. Esposito, and thank you, Mr. Chairman.

Chairman NEAL. Thank you, Mr. Larson. Perhaps we could get an answer in writing from Goldman. If we inquire, they could help us with that detail.

Mr. ESPOSITO. We will do our best to provide that.

Chairman NEAL. Sure, sure. Mr. Heller, the gentleman from Nevada, is recognized to inquire.

Mr. HELLER. Thank you very much, Mr. Chairman. And I want to thank you for putting this panel of experts together. I have—it has been a very interesting hearing.

I wanted to move back to this chart that you showed recently, and I guess if there was a comment to be made on that, I would say that it looks pretty volatile, and—going back from September of 2008 through this month.

I guess, with the dislocations and everything that you spoke of on this particular chart, I guess my question is, as I look at something like this, I am more concerned about where we're going to be a year from now, or 2 years from now. Is there any work that is being done, in trying to anticipate, with our current economic conditions, what that red line is going to look like, as opposed to where it is today?

And the reason that I bring that up is that, you know, I think there is going to be an economic recovery. And I think most people agree that within—perhaps by the end of the year, first part of next year, but they are also talking the impact of inflation and higher rates, because of some of the activities in this Congress.

I would like to know what is going to be the long-term impact of this red line by decisions that are made in this Congress, as it pertains to unemployment, inflation, and perhaps higher rates—if that is a fair question?

Mr. ESPOSITO. It is a fair question, and I think part of the answer to your question will also depend upon whether or not Congress considers expanding and extending a program like the Build

America Bond program. You have successfully addressed the demand side of the equation. You have allowed States and local governments to tap into a much broader and larger pool of liquidity.

In a world where supply has remained somewhat static, at least into 2009, by addressing the demand side of the equation, you have helped lower that red line that represents the borrowing cost to municipalities. If you consider extending that program, as we look out into 2010 and 2011, I think we would be much more optimistic that that red line can continue to trend lower, and remain that way almost regardless of what the economic backdrop plays out to be.

That demand side of the equation is incredibly powerful. The investment grade corporate market is deep, and it is liquid. And so, if we can consider extending the program, I think you will be much more successful, regardless of the economic backdrop, to keep borrowing rates low for States and local governments.

Mr. HELLER. I don't know if there is anybody else that wants to comment on that.

But I just wanted to bring up one other question, and that is we seem to have an interest in what's going on in California right now. Based on the activities just this week, their inability to balance their budget, what impact does that—and, keep in mind, I'm from Nevada, so we are right next door—what impact is this lack of—the financial crisis in California right now going to have in their municipal bond ratings, and perhaps long-term impact, nationally?

Mr. ESPOSITO. Well, one thing I would say about California, it is simply too big not to cause any knock-on effects to the broader credit markets, and specifically to the municipal market.

Mr. HELLER. I would agree.

Mr. ESPOSITO. And so, that is just something I think Congress will need to bear in mind. We are not just talking specifically about California. There is no way we can isolate the credit situation in California from the broader markets. And we think that is going to be a very important consideration as we play forward over the coming months.

Mr. HELLER. Thank you. Any other comments?

[No response.]

Mr. HELLER. If not, I will yield back, Mr. Chairman.

Chairman NEAL. Thank you very much, Mr. Heller. Just a couple of thoughts.

Certainly the use of referendum questions comes to mind in the current crisis in California, and how they have been utilized. At the same time, I think that Mr. Esposito touched on a very key point. That was the whole idea of stimulus, to address the issue of demand. And slowly, but surely, I think that we are making some progress on that front.

As panelists, you were terrific. And I think this is very, very helpful. You reminded me of my work with Mr. Houghton on private activity bonds, the AMT holiday, things that a Subcommittee can accomplish. I am very pleased with the dialogue today.

Are there other Members of the panel who would like to ask additional questions?

[No response.]

Chairman NEAL. If not, I want to thank you for your good time and good work today. We will, perhaps, have some followup questions. And you will hear from Members, and we hope that you will respond promptly.

And, if there are no further comments, the hearing stands adjourned.

[Whereupon, at 11:22 a.m., the Subcommittee was adjourned.]

[Submissions for the Record follow:]

Statement of Cadmus Hicks, Nuveen Investments

Over the years, some have argued that tax-exemption is an inefficient way for the Federal Government to help State and local governments lower their borrowing costs, because tax-exempt bonds may be held by people in the highest tax brackets, even though they are priced to produce the same after-tax returns as taxable bonds held by investors in lower tax brackets. For example, during 2006 and 2007 (before turmoil in the credit markets caused Treasury yields to plummet as investors became extremely averse to risk), the average yield of 10-year, triple-A rated, tax-exempt general obligation bonds was 81% of the average yield of 10-year Treasury notes, which implies that an investor with a marginal tax rate of 19% would have the same after-tax return from either security (based on the Thomson Reuters, Municipal Market Data scale, ignoring differences in credit quality, call provisions, etc.). However, if the investor were in the 35% tax bracket, the tax-exempt bond would produce a much higher after-tax return than the Treasury note. If a Treasury note yielded 5.00% before tax, its net yield after paying taxes at a 35% rate would be only 3.25%, which is well below the 4.05% yield of a tax-exempt bond that yielded 81% of the Treasury yield.

To the extent that tax-exempt bonds are held by investors in the highest tax brackets, it would appear that the reduction in State and local borrowing costs made possible by tax-exemption is less than the loss of tax revenue to the U.S. Treasury. By this reasoning, in our earlier example, the Federal Government's tax revenues are reduced by an amount equal to 35% of the interest that would be paid on a taxable bond, but the municipal issuer's costs are only 19% lower than they would be if the bond were taxable. This lost Federal tax revenue is viewed by some as a "subsidy" from the Federal Government to municipal issuers. However, this paper argues that such reasoning fails to allow for the fact that taxable municipal bonds may be purchased for tax-deferred and other accounts that have lower effective tax rates. Consequently, the amount of tax revenue that the Federal Government forgoes due to tax-exemption is considerably lower than it would be if the only alternative to buying a tax-exempt bond was to purchase a bond whose interest is fully taxable in the year it is received. This paper also shows that the relative pricing of tax-exempt bonds reasonably reflects the benefit of tax-deferral on taxable bonds.

The issuance of taxable Build America Bonds (BABs) illustrates the dynamics at work in the relative pricing of tax-exempt securities. On Wednesday, April 22, the State of California sold $3 billion of BABs, maturing in 2039 with a yield of 7.40%, which was approximately 3.60% above the yield on 30-year Treasury securities. Because the State chose to retain the tax credit rather than pass it on to investors, the State will receive payments from the U.S. Treasury equal to 35% of each interest payment, which lowers the State's net cost from 7.40% to 4.81% ($7.40\% \times (1 - 0.35) = 4.81\%$). This effective interest rate was well below the yield of 5.47% that the State's outstanding tax-exempt, 30-year bonds were offering at the time of the sale. The after-tax return of the BAB and the tax-exempt bond would be the same if someone had a 26% marginal tax rate ($1 - (5.47 / 7.40) = 0.261$), which means that tax-exemption reduces that State's interest cost by 26%. (Unlike the State's BABs, the tax-exempt bonds are subject to optional redemption at par in 10 years. Without that call provision, the yield would have been 0.10% to 0.15% lower.)

This discrepancy between tax-exempt yields and the net borrowing costs of BABs raises several questions. Is the State's tax-exempt borrowing rate higher than it should be? Is the Federal Government giving up more in potential tax revenue than the municipal issuers are saving through tax-exemption? Is the amount of tax revenue the Federal Government will collect on taxable BABs at least as great as the amount of the payments it will make to the issuers of BABs? For tax receipts to equal payments to issuers, all BABs would need to be held by investors in the 35% tax bracket, which is clearly not the case, since many of the BABs have been sold to pension plans and foreign investors. This implies that the amount of tax revenue that would be lost if the bonds were tax-exempt will not be as great as the cost of the tax credits paid to issuers.

Tax-exemption is efficient if the savings enjoyed by municipal issuers are at least equal to the amount of tax revenue the Federal Government would receive if the bonds were taxable. In such an analysis, the tax generated by BABs is a measure of how much Federal revenue would be lost if the bonds were tax-exempt. Thus, the reason why net borrowing costs are lower on BABs than on tax-exempt bonds is likely to be because the U.S. Treasury has agreed to pay more to issuers than it will collect in tax revenue. To the extent that taxable municipal bonds are held by investors with effective tax rates of less than 35%, tax-exemption is a more efficient way of supporting State and local issuers than might appear at first glance. In the case of the California bonds discussed earlier, the effective tax rate on its BABs must be at least 26% in order for Federal tax revenue from BABs to exceed what the State would save if it sold tax-exempt bonds instead.

The Ratio Curve

From the time when BABs were first proposed, market participants recognized that issuers would enjoy the greatest cost savings on bonds with the longest maturities, because tax-exempt bonds with longer maturities tend to have yields that are higher as a percentage of taxable yields than do shorter maturities. The question is whether the upward slope of the "ratio curve" implies that tax-exemption is less efficient for longer maturities. Various factors have been cited to explain the upward slope of the ratio curve:

(1) Compared to most taxable debt, municipal issues tend to be structured with multiple serial and term bonds, which are more heavily weighted toward the long end in order to produce level debt service (with principal payments increasing and interest payments declining over time). The added supply of long bonds causes their yields to rise relative to taxable bonds.
(2) Investors want to be compensated for the possibility that tax policy could change over time in a way that makes tax-exempt bonds less attractive.
(3) Yield quotes on municipal bonds generally are based on bonds that can be redeemed, or "called," at the option of the issuer many years before their stated maturity date. In exchange for this option, issuers pay higher interest rates than they would on noncallable bonds, which are more common in taxable markets.
(4) Relative to Treasuries, municipals have more credit risk, and the longer the maturity, the more time in which negative developments could occur.

The Benefits of Tax-Deferral

Another factor that may affect the tax-exempt/taxable ratio curve is the fact that tax-exempt bonds do not just compete with fully taxable securities, but also with what might be termed "tax-deferred investments," i.e. bonds held in vehicles where the income is not immediately taxed in the year it is earned. Furthermore, since the benefit of tax-deferral increases with longer time horizons, and since tax-deferred vehicles are typically used to fund long-term liabilities (such as pension obligations and individual retirement plans), one would expect bonds with longer maturities to be favored for such vehicles.

The longer a security is held on a tax-deferred basis, the lower the effective tax rate on that security. For example, suppose that someone places into an Individual Retirement Account a taxable bond that cost $100,000, matures in 30 years, and yields 7%. Suppose further that the investor expects to be in the 35% tax bracket when he or she withdraws bond principal and accumulated interest from the account. If interest on the bond were reinvested at 7% and allowed to accumulate tax-deferred, at the end of 30 years that investment would be worth $761,226, of which $100,000 was the original principal and $661,226 was the amount of interest earned. Tax on the interest earnings would be:

$231,429 (0.35 × $661,226 = $231,429).

The ending value of the investment after the payment of taxes would be $529,797, which represents an annual rate of return of:

5.72% ((529,797 / 100,000) ∧ (1/30) = 1.0572).

This return of 5.72% is 81.6% of the 7.00% pretax return, which implies an effective tax rate of 18.4%. The following table shows the calculation of the implied effective tax rate for bonds held on a tax-deferred basis for different periods of time.

After-Tax Rate of Return and Implied Tax Rate on a Tax-Deferred Investment of $100,000 Yielding 7% With Earnings Reinvested

Number of Years	Ending Value	Tax Liability	After-Tax Value	After-Tax Rate	After-Tax Ratio	Implied Tax Rate
1	107,000	2,450	104,550	4.55%	65.0%	35.0%
2	114,490	5,072	109,419	4.60%	65.8%	34.2%
5	140,255	14,089	126,166	4.76%	68.0%	32.0%
10	196,715	33,850	162,865	5.00%	71.4%	28.6%
15	275,903	61,566	214,337	5.21%	74.5%	25.5%
20	386,968	100,439	286,529	5.40%	77.2%	22.8%
25	542,743	154,960	387,783	5.57%	79.6%	20.4%
30	761,226	231,429	529,797	5.72%	81.6%	18.4%

Past performance is no guarantee of future results. This hypothetical example has been provided for illustration only. Other methods may produce different results, and the results for individual portfolios may vary depending on market conditions.

The table demonstrates that the longer the maturity, the greater the potential benefit to the investor from deferring taxes on the security, and, therefore, the greater the potential present value loss of tax revenue to the U.S. Treasury from tax deferral. *When estimating how much potential revenue the Treasury loses when municipalities sell tax-exempt bonds, one should deduct the amount of revenue that could be lost if the municipalities sold taxable bonds that were bought held in tax-deferred accounts.*

Tax-Deferral and the Ratio of Tax-Exempt to Taxable Yields

As it happens, the ratios of after-tax to pretax returns on investments held in a tax-deferred account for various lengths of time resemble the ratio curve of tax-exempt to Treasury yields. The following table shows the average ratio of municipal to Treasury yields during 2006 and 2007, and compares those ratios to the after-tax ratios from the preceding table.

Years to Maturity	Muni/ Treasury	After-Tax Ratio
2	77%	66%
10	81%	71%
30	88%	82%

Sources: Federal Reserve Board constant maturity Treasury series, Thomson Reuters Municipal Market Data.

While the ratio of municipal to Treasury yields is generally higher than the after-tax ratio (owing to differences in credit quality, call provisions, liquidity, etc.), the differences between the ratios for different maturities are comparable. For example, the 10-year municipal/Treasury ratio is four percentage points higher than the 2-year ratio, while the 10-year after-tax ratio is five points higher than the 2-year after-tax ratio.

The effect of tax-deferral on the relative yields of tax-exempt bonds has important implications for tax policy. Congress has estimated that the BAB provision will cost the Federal Government $4.35 billion over 10 years. Given the fact that over $7.5 billion of BABs were issued in just the last 2 weeks of April, and that most of these issues had maturities as long as 30 years, the Federal Government may find that the cost of making direct payments to issuers is considerably higher than the "subsidy" produced by tax-exemption. If the Treasury Department and Congress were to compare the costs of payments made under the BABs program with the Federal tax revenue derived from such bonds, we would not be surprised if they concluded that taxable bonds with tax credits are not really any more efficient than tax-exemption as a means of lowering the borrowing costs of State and local governments, and may even be more costly in the long run.

Cadmus Hicks,
Nuveen Investments

Statement of Dean A. Spina

I propose that Congress eliminate the current penalty on religious organizations that results from application of the Federal tax-exempt bond laws. Religious organizations, from churches to religious colleges and schools, are denied the low rates of interest available through tax-exempt bond financing. This is because tax-exemption is derived from the issuance of bonds by a State or local issuer and the loan of bond proceeds to the borrower.

The First Amendment is an obstacle to the use of tax-exempt bond financing for religious organizations. As a result, religious organizations, and some related organizations such as schools, are denied tax-exempt bond financing that is available under Internal Revenue Code Section 145 to all other 501(c)(3) organizations.

A direct exemption of religious organization debt would not violate the Constitution. A direct tax exemption is different than the use of the State or local governmental power to issue debt and loan the proceeds to a religious organization.

Amending the Internal Revenue Code to exempt interest on debt incurred by a religious organization (to the same extent it would be so recognized for debt issued by a State or local unit of government for a 501(c)(3) organization under IRC Section 145) would remove the penalty on religious organizations without the necessity of the involvement of any unit of State or local government.

Following this statement is a draft of legislation to enable a religious organization to elect to be covered by certain tax-exempt bond provisions and thus have tax-exempt debt and substantially lower interest cost. Borrowing $1,000,000 for 20 years at a taxable interest rate of 8.5% requires payment of $370,000 more interest than the same loan at a tax-exempt rate of 5.95%.

This proposal will benefit tax revenues. Tax revenues should be increased if lower borrowing costs enable religious entities to proceed with projects that might not otherwise be undertaken. More construction generates a demand for goods and services, and creates more taxable income. Moreover, Federal and State tax revenues could be positively impacted by lower borrowing costs. If religious organizations need smaller charitable contributions to finance a project, charitable tax deductions should be smaller. Most church financing is ultimately paid for by deductible charitable contributions.

I am an attorney and I am active in the use of tax exempt bonds for 501(c)(3) organizations. This proposal is not made on behalf of any client. This proposal is driven by the belief that Congress should act to rectify the current tax-exempt bond laws to enable religious organizations to enjoy the same rates of interest enjoyed by all other 501(c)(3) organizations.

Thank you.

Dean A. Spina

DRAFT LEGISLATION—TITLE 26—INTERNAL REVENUE CODE

PART IV–TAX EXEMPTION REQUIREMENTS FOR STATE AND LOCAL BONDS

Subpart A—Private Activity Bonds

Sec. 145. Qualified 501(c)(3) bond

Add to Section 145 of the Internal Revenue Code the following:

(f) Election by religious organization

This section shall apply to a religious organization obligation if—

the religious organization elects to have this section apply to such obligation, and
the religious organization reports the election in such form as the Secretary may require.

For purposes of this subsection, the following shall apply to the religious organization obligation: Subsection 147(b),[1] Subsection 147(e),[2] Paragraph (1) of Subsection 147(g),[3] Paragraphs 2 and 3 of Subsection 147(h)(2),[4] Section 148,[5] Subsection 149(e)[6] and Subsections (b) and (c) of Section 150[7] and in applying the foregoing, the religious organization shall be deemed to be an issuer.

For purposes of this subsection a "religious organization" means a 501(c)(3) organization which is exempt from tax under section 501(a) as a religious or religious education[8] organization and a "religious organization obligation" is any debt obligation of a religious organization incurred by the religious organization on or after the date of enactment of this subsection and prior to January 1, 2019, for

—the religious organization's financing or refinancing of the acquisition,[9] construction, reconstruction, or renovation of a facility to serve the needs of its members[10] for appropriate objects of the religious organization and to serve the community (including providing services such as preschools, daycare and assistance[11] to the needy through the religious organization or an organization controlled by or affiliated[12] with the religious organization, provided such use of the facility does not result in an organization having income subject to tax[13] under this Subtitle A) or

—to make one or more loans to an affiliated religious organization for such a facility.[14]

The religious organization that makes the election under this subsection with respect to its obligations for a facility (but not for an obligation to fund loans to affiliated organizations) shall be a qualified small issuer for purposes of subclause I of Section 265(b)(3)(B)(i), provided that in any calendar year the religious organization designates no more than the amount that may be designated under subparagraph (C) of Section 265(b)(3) and the designation is reported by the religious organization in the manner required by the Secretary.

Statement of Peter B. Coffin, Breckinridge Capital Advisors, Inc.

Breckinridge Capital Advisors, Inc. strongly supports the new Build America Bond program, but we are concerned that institutional investors are unlikely to make a meaningful long-term allocation to these issues if the program expires on December 31, 2010. We firmly believe that to ensure the continued success of the Build America Bond program, its term must be extended. The sooner this extension takes place, the sooner Build America Bonds will be established as a credible asset class for institutional investors.

A Registered Investment Advisor, Breckinridge Capital Advisors manages over $9 billion in municipal bond portfolios on behalf of institutions and high-net-worth individuals. We believe the Build America Bond program provides much-needed depth to the municipal market by broadening demand beyond the traditional buyers of tax-free bonds. This has already significantly lowered municipal borrowing costs while improving secondary market liquidity.

To date, Build America Bonds have been attractively priced as new issues, and are performing well in the secondary market. As such, they have been a good "trade" for investors and the appetite for the bonds has been solid, reflecting positive momentum from early success. However, sustainable demand cannot be based

[1] Bond maturity.
[2] Prohibited uses.
[3] Limit on costs of issuance from obligation proceeds.
[4] 501(c)(3) bonds are exempt from certain limitations.
[5] Arbitrage.
[6] Reporting requirement.
[7] Change of use.
[8] Educational organizations affiliated with a religion have been able to use tax-exempt bond financing. This provision would overcome concerns about entanglement.
[9] Acquisition includes an existing facility without a requirement of rehabilitation.
[10] For example, religious worship and education.
[11] Food pantries, clothing and household distribution, shelters and education and training for the poor and distressed.
[12] This would allow a separate organization to be formed to operate a preschool program or summer program for disadvantaged youth and use the facility.
[13] Avoids tax-exempt debt being used to build "Sunday school" classes that are used throughout the week for non-affiliated daycares or preschools, some of which may be for profit entities.
[14] Church extension funds oftentimes borrow from church members to fund loans to churches within the denomination.

on short-term profits. Eventually, Build America Bonds need to be recognized as an important core allocation in an institutional fixed income portfolio.

Institutional investors prize the safety, reliability and the relatively long duration of Build America Bonds. This is especially true after the recent difficulties in other sectors of the fixed-income markets. Moreover, many public pension funds and charitable endowments will welcome the opportunity to invest in communities through Build America Bonds, but only if the current expiration date of December 2010 is extended.

The Federal Government has long seen value in subsidizing State and local government borrowing. Today we understand that the traditional form of that subsidy—exempting municipal interest from taxes—is not always completely effective in reducing a municipality's borrowing costs and maintaining its access to capital. The Build America Bond program introduces a new form of subsidy that has had early success in broadening municipal demand thus, improving the overall effectiveness of the Federal subsidy. Breckinridge believes an extension of the Build America Bond program will ensure even greater and more sustainable success for the future.

Statement of Seamus O'Neill, Liscarnan Solutions

Mr. Chairman, Members of the Subcommittee—Good morning, I am Seamus O'Neill of Liscarnan Solutions, LLC based in McLean, Virginia. I have more than 28 years experience as an investment banker and financial advisor. For the past 20 years, I have been a financial advisor and project consultant to the student loan industry, including the nonprofit lenders in California, Ohio and Montana, who have a combined debt outstanding of approximately $4.5 billion.

While this hearing is aimed at addressing issues facing government issuers of both tax-exempt and taxable debt, I would like to discuss very similar issues concerning nonprofit and State agency student loan issuers.

Nonprofit and State agency student loan providers, who combined have more than $30 billion of outstanding taxable and tax-exempt debt financings, are facing two significant issues caused by the financial markets meltdown. The first issue concerns their outstanding tax-exempt financings, which have been damaged by the financial crisis, and what needs to be done to make these financings marketable. The other issue concerns the ability of nonprofit and State agency issuers to access financing for new student loans.

Unmarketable Outstanding Financings

In February 2008, the financial markets meltdown impacted the tax-exempt student loan sector. This meltdown has produced two results—(1) it has destroyed much of the balance sheet value of the student loan non-profits and State agencies due to the failed financing structures; and (2) it has prevented such issuers from refinancing these failed bond issues because their access to the tax-exempt bond market has been cut off.

When the variable rate market for student loan notes froze, billions of dollars of tax-exempt variable rate student loan financings became unmarketable. Investors, including pension funds, institutional investors and individuals, were no longer willing to buy or sell student loan securities. In addition, the interest rate on these financings went to a maximum rate, meaning that these financings have been paying the maximum rate of interest allowable under their financing documents—a rate that was never contemplated for the life of the bonds and is unsustainable in the long-term.

One of the important reasons for our inability to restructure failed tax-exempt financings is the lack of variable interest rate financing in the tax-exempt bond market. The tax-exempt student loan bond market is primarily a fixed interest rate market, while our Federal student loan assets earn floating interest rates. Thus, we have a mismatch between the interest earned and interest expense. This mismatch was solved in the past by creating tax-exempt variable interest bonds synthetically, either by using a bank liquidity facility or an auction mechanism. However, in today's dysfunctional financial markets, these options are no longer available, meaning that the rates cannot be matched. As a result, tax-exempt financings for Federal student loans are unmarketable and the frozen financings cannot be restructured.

Fortunately, there are solutions. Tax-exempt student loan bonds have already been temporarily relieved of the Alternative Minimum Tax. Unfortunately, this benefit does not solve the mismatch between interest earned on loans and interest expense on bonds. Our proposed solution is to expand the availability of the Taxable Bond Option to student loans. We believe that our solution should produce a neutral budget score given that we are substituting Taxable Bond Option bonds for existing tax-exempt bond authorization.

Expansion of Build America Bonds

The subject of this hearing involves the "Build America Bond" included in the American Recovery and Reinvestment Act. The "Build America Bond" is essentially an idea referred to as the "taxable bond option." The ARRA allowed for the use of this bond by State and local governments to help these governments restructure existing debt, as well as issue new debt. As student loan debt is facing many of the same problems as State and local government debt, it would be consistent to extend the ability to issue these bonds to tax-exempt student loan issuers.

By extending this bond, issuers of tax-exempt student loan bonds would be permitted to issue taxable bonds and then receive a rebate of 35 percent of the interest they pay to investors. This credit would have the effect of reducing the taxable bond interest rate down to a tax-exempt rate while permitting the issuer to access the taxable market. The issuance of these taxable bonds would be subject to all Federal and State limitations currently affecting the issuance of tax-exempt bonds.

The taxable bond market is much more accommodating to the issuance of variable interest rate bonds; thus, permitting issuers of student loan bonds to better match the interest rates on their loans and liabilities. Access to these bonds will remarkably improve the potential for restructuring the damaged balance sheets of student loan non-profits and State agencies. In the end, the marketability of these bonds would be restored and billions of dollars of frozen financings could be restructured saving hundreds of millions of dollars for the benefit of students and their families.

Access to New Financing for Loans

This hearing is concerned with the taxable bond option but there are other issues that can be addressed in this area that would greatly impact the availability of funds from tax-exempt financings for the benefit of schools and students.

While the taxable bond option would greatly help tax-exempt issuers in restructuring existing financings, steps can be taken to permit tax-exempt issuers to utilize the tax-exempt market for new loans, most notably in the area of private loans.

Even with the increase in Pell Grants and Federal loan limits, there is still a great need for private loans, i.e. those loans not guaranteed by the Federal Government. Historically, these loans have been provided by banks, for-profit lenders and some State agencies. However, lenders have pulled back in offering these loans. The remaining loans are costly for students to borrow. The only bright spot for students is in the 13 States that have a private loan product offered by a State agency.

In addition, other sources of college funding are scaling back. Parents are less likely to be able to tap their diminished home equity; 529 education savings plans have taken significant investment losses; college endowments have been similarly damaged; institutional aid has become strained; and State government resources and tax revenues are in decline.

Students are finding it harder to come up with the resources necessary to fund the gap in their education expenses (i.e. the gap between what they can get from the Federal Government and what they owe their college).

Nonprofit lenders would like to help fill this gap by providing low-cost private loans. However, nonprofit lenders have been unable to utilize its tax-exempt financing for these loans because of the restrictions of Section 150(d) of the Internal Revenue Code.

Students would be greatly served if nonprofit lenders had access to tax-exempt financing for private loans. As such, the restrictions in 150(d) should be modified to permit nonprofit tax-exempt issuers to utilize its tax-exempt financing for private student loans. In making these loans, the nonprofit issuers would work in partnership with their respective States to ensure that these loans are providing a benefit to the State's students. The nonprofit status of the lender and the tax-exempt nature of the financings would result in a reasonable, fair, affordable and low-cost private loan to help students fill the gap in their college financing.

Other Changes to 150(d)

Section 150(d) should also be reformed to more easily permit nonprofit, tax-exempt issuers to better serve its State's students and schools by permitting it to directly engage in origination and servicing activities, as well as other charitable activities. Current 150(d) organizations set up an affiliate or similar entity to handle these activities, leaving the 150(d) entity to issue debt, and acquire and hold Federal loans. This wall was created in a different time and for a Federal student loan program that has been greatly transformed. There is really no good reason for the wall to exist in the student loan program of 2009.

By removing this wall and allowing one entity to serve as the issuer, originator, servicer, and charitable organization, nonprofits can better serve students and schools in the same way that State agencies do. There is a need for this change even if the Federal Government transitions to the financing of 100% of the Federal loans directly from Federal financing. This change would help nonprofits meet the needs associated with the financing and servicing of loans already made, the potential servicing of loans going forward, and the resources needed for charitable activities; in addition to the efforts of nonprofits to meet the private loan demands of students and schools.

Conclusion

The above three reforms would go a long way in repairing the balance sheets of nonprofit lenders, freeing up capital and other resources for student loans and related activities for the benefit of students and their families, at little if any cost to the Federal Government. They are commonsense changes to the Internal Revenue Code to meet today's needs.

Thank you for this opportunity to submit this testimony.

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